PROCYCLICALITY AND ACCOUNTING STANDARDS
Fair value accounting and standard-setting process

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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 abut 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 <u>"volatility effect":</u> 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 <u>"mismanagement" effect</u>: 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 <u>"misleading" or "accommodating</u>" 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 <u>"trap" effect</u> 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 t**hat 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 t**o 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.

The financial turmoil, however, shed light on the IFRS and revealed significant issues that have been partially dealt with at present. This is a perfect timing – five years after the introduction of IFRS - to start further reviewing, beyond other specific issues remaining to be addressed in urgency, why such problems arose and which action it calls for.

Failure to deal with these problems and take proper action would obviously raise questions in the EU about the appropriateness and legitimacy of fair value accounting as presently implemented.

The same is true in the United States where, in a different situation and regulatory context, the same debate takes place as many voices raise the same questions about the relevance of fair value accounting.

2. The concept of "fair value" needs to be clarified. "Fair value" means in reality two different things: the "formal" notion used in IFRS (as well as in US Gaap), which is a different and wider concept, strictly speaking, than "mark-to-market value" ; however, by extension, more often than not, "fair value" is also used, in the context of discussions about financial markets and regulation, as a synonym for "mark-to-market" value. That is why **we will use the expression fair value accounting in this document for mark-to-market accounting.**
Indeed, "fair value accounting standard setters" very rarely accept to depart from "mark-to-market" accounting as the best proxy for "fair value", as recent debates about "fair value guidance" in the context of the financial crisis have shown.
As a matter of fact, the crux of the issue very much lies in that "fair value" is a misleading term, essentially as it sounds "absolute", and seems to be an "ultimate" and correct measurement of value, and tends to be often presented as such - although **it is a highly subjective and vague concept**, which may well be a mere price, or an "opportunity cost" or any other subjective measure of value, thus not qualifying to be regarded as "true" value, or "intrinsic" or "relevant" value.

It may be safer, in the future, to more modestly expect accounting standards to merely refer to "value".

3. In the same vein, in a "symbolic" way, it would be preferable to speak of companies' "accounts" instead of "financial statements". This would allow to better grasp the *economic* nature of accounts, as opposed to the strictly financial approach implied by "fair value" – i.e. mark-to-market" accounting. This also would help to recall that accounts are not only meant to be used by investors – themselves a diversified lot – but also by management, various public authorities including regulators and supervisors, shareholders – some willing to buy or sell shares, some others simply holding their stake in the long term - employees, creditors, suppliers and all other possible stakeholders.

Actually, it would help to revert to fundamental accounting as opposed to exclusively "financial reporting" – a change in vocabulary that indeed evidences the move from economic to mark-to-market valuation.

I – THE *EFFECTS* OF FAIR VALUE ACCOUNTING, INCLUDING PROCYCLICALITY, MAY BE OBSERVED IN TIMES OF CRISIS, *AS WELL AS* IN NORMAL TIMES

The objective of accounting standards is to provide a "true and fair view" of economic and financial activities of a firm: the standards should be as "neutral" as possible, a clear mirror of a firm financial situation at a certain moment of time and of its performance over a given period of time.

Financial instruments of all kinds and even most securities are by essence complex products. One simple approach, chosen by the IASB (and FASB) as a fundamental principle, is to account for them at market price, avoiding the need to calculate their complex intrinsic value. This approach is currently -and is apparently meant to be even more in the future- the cornerstone of what is called "fair value accounting". Without deciding at this stage whether this is a right or wrong approach, it follows that *the accounts of any firm, holding such instruments, will vary in the same manner as their market prices.*

This, in turn, leads to a number of consequences, which can be summarized as follows: under fair value accounting, the “volatility” of markets is “imported” in the firm’s accounts, no matter whether it has a link with its effective performance, as a going concern. For example, a company selling goods around the globe in various currencies cannot hedge its future backlog, as would be prudent management from an economic standpoint ; the company would use hedging financial instruments, which must be accounted for at market value; this company would thus be “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.
Regarding the backlog which has been secured but yet not delivered, the currency hedges (“cash flow hedges”) relating to this backlog may generate large gains or losses in the comprehensive income of companies. These gains or losses have no economical meaning and are fully misleading when analysing the company performance.

And not only will this “import” of “raw” market variations determine, to a very large extent, the evolution of accounting results of companies, but it will also dictate their management behaviour and strategy. And, what is more and potentially leads from micro to macro effects, the market participants themselves will adjust their own understanding and behaviour accordingly. That will happen for financial sector companies, but also, albeit on a lower scale, to most non financial companies using financial products. And finally, as such accounting results are essentially market-driven and not long term performance-driven, they will all vary, for all companies, more or less in the same manner at the same time – introducing massive procyclicality,

In other words, fair value accounting has a “multiplier” effect built-in; it plays as an “amplifier” of market movements on firm’s accounts and henceforth on the markets themselves. More precisely, the pro-cyclical effect can be analysed as follows:

1. ***The “import” or “volatility” effect of fair value accounting means that financial market volatility are essentially driving firms’ accounts instead of showing economic performance***

The market price of a financial instrument is the result of a flow of transactions executed by some market participants involving variable amounts of capital. When one values at the same price the portfolios of such instruments in the balance sheet of all global market participants, one measures the value of the stock of those instruments worldwide on the basis of the price resulting from this last transaction on the market. And if the market price is volatile, fair value accounting transfers this volatility to the whole stock of instruments.

It is often said that this volatility is “real”, so that it has to be reflected in the companies’ accounts. There is no doubt that volatility results only from the behaviour of economic actors, including market participants. But this volatility is only “real” for those companies with a business activity essentially linked to the financial markets, whereas it may have no relationship with the performance of other companies. That is precisely the distinction to make, in order to realise that accounting standards cease to be “neutral”, as soon as this “imported bias” is imposed on accounts of firms that do not have strategies based on financial market transactions per se -like investment banking – for sure all industrial companies, and commercial banks as well.

As fair value accounting results in “importing” market prices directly in firms' accounts, it is mechanically pro-cyclical as all market participants will themselves adjust market reactions to market-driven results, typically a circular phenomenon. It will therefore be necessary to question whether it is relevant for the economy as a whole to “pay this price”, and how and when this should be avoided.

2. ***The “mismanagement” effect of fair value accounting means that strategic decisions are made on the basis of instant market prices***

Adversaries of fair value accounting suggest that, instead of providing transparent and realistic information, it is more probably misleading investors:

- results are volatile and reversible, depending on market conditions, which prove to be highly and vastly unpredictable and unrealistic ; if this is specifically true in times of turmoil, it can indeed be shown that the volatility of financial markets is higher than the volatility of the non-financial economy ;
- therefore, results are only potential results , – which may prove fictitious if the firm doesn't liquidate its assets immediately , and when it will, market conditions might be completely different ; therefore fair value accounts – named "*financial statements*" under US Gaap or IFRS – do only give a useful indication if the company is supposed to be liquidated in pieces at once, which is not relevant for a company considered as a "going concern" ;
- therefore, strategic management decisions like investment choices, restructuring decisions, incentive policy or dividend policy or any other decision made by the management on the basis of fair value accounting is subject to the same risk of error, namely to reflect strictly current market decisions and, yet, base medium or long term orientations or incentives on that inappropriate ground; apparent logical management decisions might well soon prove unwise and will always prove to be fundamentally pro-cyclical ;
- management decisions will affect in their turn all other possible reactions by stakeholders of all kind, thus defusing a pro-cyclical effect to the markets and the economy more widely.

Fair value accounting has immediate and real consequences on management and stakeholders decisions, which tend to become more and more pro-cyclical.

3. ***The "misleading" or "accommodating" effect of fair value accounting is less often identified : in essence, all firms' results being made cyclical, it hides the formation of a bubble***

During the period of formation of a bubble, fair value accounting will show a deviation in prices but will not prevent participants from riding the bubble. Indeed al market participants will not likely realise the deviation as it will affect many segments of markets and economy in the same pro-cyclical manner. Furthermore, market participants will even "need" such pro-cyclical deviation to take place to ensure consistency in the evolutions across all market segments. **Finally, it will profitable to all of them**: investors see the value their portfolio growing, the management and their employees see their bonuses rocketing and institutions experience higher short term returns.

Not only does fair value accounting not reveal 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 instead of preventing bubbles fair value accounting on the contrary is hiding or even encouraging them until they burst.**

4. ***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 market are not functioning, in time of crisis or for any other reason***

In times of financial turmoil, the market price is not the result of a significant flow of transactions, including those of arbitrageurs, and it is no longer related to the economic and financial parameters of the financial instrument. It includes a deep illiquidity discount which reflects the specific market conditions on times of crisis.

This price is totally irrelevant to measure portfolios of instruments which have no prospect for immediate liquidation; if applied, it generates illegitimate management decisions which are against the interests of investors, shareholders and stakeholders and the whole market place.

We experienced such situation in 2008, characterized by a "vicious circle" described many times since the crisis broke up. As the market value of some assets declined, and even before the corresponding market segment becomes illiquid, institutions holding these assets must sell them in order to restore their situation, which drives the price of assets further down, until the market becomes illiquid and some firms go bankrupt. It remains to be seen whether that means that the "true" value of the assets sold in distress was the sale price. It is likely that the flow of cash revenue linked to these assets, although obviously lower than expected, would have been significantly higher in normal market circumstances. All transactions made on such assumptions will be mispriced and flawed, and misleading for all those who take part in them.

A specific note has to be made here, as this "vicious circle" concerns those market participants whose business activity is essentially linked to financial markets. Fair value accounting is adapted to their activities, mainly focussed on originating, buying and selling financial products for themselves or clients. In the EU for example, no accounting standards existed for such financial instruments before IFRS; and fair value accounting appears to be the right accounting method for such products in normal market conditions.

Yet, interestingly, in unusual and extreme market conditions, fair value accounting proved to be harmful as it contributed to lead the markets and the economy to a trap. Immediate measures of different kind had to be taken, including changes to the accounting rules or their implementation.

To revert to more realistic rules was not, as sometimes said, "to break the thermometer": when the instruments of a car or plane are broken and do not show the North or speed or altitude, whatever their function is, one definitely -and rightly so - needs to change or repair the broken thermometer. As highly undesirable as it is to have to do it in times of distress, it proves wise to act in such state of emergency.

Fair value accounting may be considered as having significantly contributed to billions of distressed sales and losses which could possibly have been avoided, therefore exacerbating the financial crisis.

II – THE *CAUSES* OF FAIR VALUE ACOUNTING PROCYCLICAL EFFECTS ARE TO BE FOUND IN THE CHOICE TO BASE –AND INCREASINGLY DEVELOP –ACCOUNTING STANDARDS ON ONE "FITS-ALL" MODEL BASED ON INSTANT MARKET VALUATION.

1. The fundamental choice underpinning fair value accounting is to rely for all valuation on the market as much as possible, and on the balance sheet as opposed to performance or business activity – and this may not be the best way to provide a "true and fair view".

- Understanding the fundamental choice underpinning "fair value accounting" has to start from a "conceptual" angle. The "fair value dogma" is based on a theory that can be called the primacy of Assets Theory also referred to as the "asset and liability view" in which income is a measure of the increase or decrease of the net asset value of the enterprise during a specified period. The basis of conclusions to the Exposure Draft on the Conceptual Framework describes this IASB's "critical idea" of measuring net assets to determine income. This suggests that earnings should be measured by reference to the changes in the present value of individual assets' prospective cash inflows based on the idea that a business may be presumed to invest in assets for the future net cash equivalent flows that they can be expected to generate.
  Yet this is an incomplete representation of business that generates net cash inflows. The sum of economic resources employed by a business activity – that is cash and non cash resources – is greater than its assets in general, and assets in a balance sheet at measurement date, in particular.

- In other words, it seems that fair value accounting is making all attempts to close the gap between accounting and market capitalisation, indeed the best observable information regarding the value of a listed company. Yet, we are still far from that goal : even instant market capitalisation reflects many factors that are not accounted for such as the goodwill generated by a company or relative value considerations, or many other elements related to the general economic context or even beyond.

  And it is fully justified that accounting does not match market value: accounting rules serve different purposes, respectively the "image" of the company's economic situation, both in a static (balance sheet) and dynamic (statement of income) manner which complement one another ; the market value attempts to capture in only figure all information – using company's accounts as a base, obviously, but not only and referring also to non economic information – about the value of a shares in the company, and vary constantly : why should those two references necessarily coincide ?

Yet the goal of relinquishing accounting in the hands of the markets typically justifies in the eyes of some, the goal to move towards a "full fair value" model. Accounting would be free at last from any valuation made by anybody else than the mass of market participants at some instant in time.

- These two considerations converge: as the measurement of growth when it did not include an indispensable "residual factor", fair value accounting fails to apprehend many elements of what is the "performance" of a firm. "Performance" is however a key component, if not the essential element of a "true and fair view" that accounting is supposed to provide. This is even the economic information that all stakeholders and market participants need to appreciate the so-called "stewardship" role of the firm's management, on which to base well informed policy decisions of all types.

2. The Conceptual Framework present project reflects this fundamental choice of market valuation : a consistent approach focussed on the needs of short term investors, without consideration of many other economic dimensions including financial stability, specific business models or economic environment

- The objective set for accounting standards is to serve the needs of investors. Whilst the needs of investors must be a major objective of accounting standards, the current approach ignores the variety of investor needs. Other stakeholders are also ignored.

- Financial stability is not considered in the conceptual framework. Financial stability, however, is in the interest of investors as well as all other stakeholders. Ignoring financial stability as a critical element of the conceptual framework is flawed and contradicts the fundamental needs of investors. Hence the international accounting framework emphasises short term rather than medium or long term considerations.

  Not taking the medium term into consideration, the "conservatism principle" is no longer relevant for the standard setters, although it has been traditionally a cornerstone of accounting and a very important factor of company stability. No wonder that issues like "dynamic provisioning" cannot be accommodated under a fair value accounting framework.

- International accounting standards ignore the fact that various business models exist, as it purports to account for transactions in the same manner whatever the business model is. Reflecting the instant value of a financial instrument, i.e. the price that a seller could obtain now if it were to sell it, does not provide a "fair" (free from bias or deception) representation of an instrument that is planned to be held to maturity such as a loan: a loan of 100 to a creditworthy borrower will be repaid 100 plus interest over time. Showing gains and losses as interest rate fluctuates is deceptive as the lender will cash in 100, not less, not more.

- Avoiding to leaving too much space to business decision in accounting is a normal goal for standard-setter or regulators, who strive for as much neutrality –and comparability- as possible. Yet this objective seems to be so dominant in fair value accounting, to a growing extent, that it proves counter-productive :
  - Assuming a general lack of integrity in financial reporting cannot be a sound basis of regulation. Rather, the real economic use of assets needs to be reflected with proper safeguards build to avoid abuse.
  - According to international standard setters fair value accounting enables comparability as management intent has no influence. The comparability achieved under such an approach is only apparent; comparability should be questioned if management real use of assets and decisions are not captured.
  - The economic use of assets currently drives some aspects of accounting, but in most cases strict conditions prohibit to reflect changes of use in the financial statements, by lack of confidence in the preparers, and the development of "anti-abuse" provisions. Some examples are:

  - If the objective is to trade, then mandatory classification in the trading category and reclassification out of the trading category is restricted to very limited cases (even with the new amendments) ;
  - If the objective is originally to held until maturity, and hence account at amortised cost, then impossible to sell without a sanction ("tainting rule") : is it always justified, are there not changes in real life, and can they be accommodated without allowing manipulation by management ?
  - If use of the "fair value option" is made, respecting conditions set for it, then no possibility to go out of this category (even with the new amendments), which is however inconsistent with the trading category.

3. The current model carries significant imperfections because current IFRS principles are based on rigid assertions even if recent evolutions have allowed more flexibility; here are some examples :

- The impairment model is flawed :
  - For equity instruments, reversing a loss recognized into the income statement when the value of the instrument subsequently increases is not possible (asymmetrical treatment and inconsistent with debt instruments)
  - For debt instruments, the impairment charge is calculated on the basis of the fair value of the instrument and not on the basis of the estimated recoverable cash flows (inconsistent with other type of assets)

- The reporting model intends to provide cash flow predictive information. Market value achieves that objective in active markets for trading activities. However, market value is not cash flow predictive for long term activities such as those where assets or liabilities are carried to maturity. The lending activities or borrowings issued by a company are examples of this. The contractual value is the best cash flow predictive information for a borrowing that most companies will pay at maturity. Market values which may vary above and under the contractual value are meaningless.

- The use of fair value is often counter intuitive and lead to solutions beyond common sense:
  - Fair valuing liabilities requires taking into account changes in own credit risk: the implication of this rule is that a company records a profit when its performance worsens and a loss when it is better managed and its performance improves. This accounting which record unrealised losses and gains, that in most cases will never be realised, is deceptive. Anything less than the entirety of the liability in the balance sheet would not fairly present an entity's financial position, and arguably must be judged to be fraudulent disclosure. In addition, there is no disclosure that can adequately replace a valid liability that has been sponged from a balance sheet via fair market rationale. Good disclosure cannot cure bad accounting.
  - Current rules impose the use of the same "market value" for small positions and for large positions,
  - Marking loans carried to maturity to markets result in showing gains and losses that will never be realised.
  - Current rules impose to put in the trading book the syndication of loans in a LBO because these loans are to be sold. But, until recently, even if these loans could not be syndicated anymore, it was impossible to transfer them to the banking book while they were to be held to maturity.

- <u>Derivatives must be accounted for at fair value at all times</u> ; this dates back to the 1980's and 1990's, when derivatives emerged as the main type of new financial products and some standard-setters decided that they had to be marked-to-market, as the only means to protect firms and investors from their potential risks. As all innovations, derivatives were used, for the worst and better, in different manners. Very few distinctions have been made however, although the purpose of buying derivatives can vary from one firm to another, notably between financial or non financial businesses. In other words, it would be useful to revisit this issue to ensure that it remains justified at all times.

- The crisis highlighted examples illustrating the drawbacks of this system:
  - The same products, now allowed to be transferred from the trading book to the banking book of major banks, still cannot be removed from the fair value option by insurance companies, although the stakes for financial stability are exactly the same ; this is what the EU Commission has asked the IASB to further change before end 2008 ;
  - "Monoline" insurers, being forced to revaluate their commitments to future losses, were severely endangered while their engagements were not due in the short term.

4. The extended use of fair value accounting beyond the present state of play is not decided but international accounting standards are undoubtedly, albeit not always explicitly, leaning towards greater use of market values.

- In the March 2008 discussion paper "Reducing Complexity in reporting Financial Instruments", the IASB proposed to develop intermediate approaches, because it recognized there is still work to be done on the definition of fair value, but clearly set the long-term goal as being accounting of all financial instruments at fair value, i.e. a full fair value approach ;

- the IASB justified this goal because current diversity in accounting for financial instruments (current mixed model) creates too many problems and too many rules ;

- in fact, complexity does arise because financial instruments are complex by themselves. But under the current dogma of "all derivatives at fair value", the only common accounting method for all financial instrument can *mechanically* only be fair value, regardless of the economic meaning of each instrument valuation.

The potential evolution of fair value accounting towards "more" fair value, if not eventually "full fair value" takes many forms.

In some instances, steps are taken by the IASB, which can only lead to more mark-to-market, although it is not explicitly decided yet. This is the case, for example, for the insurance sector where one side of the balance sheet is valued at fair value, creating a "mismatch" that will only be solved by fair valuing the other one, although it has no economic meaning and will only lead to marking to models the concerned items.

In a different context, the search for "proxies" also sometimes goes so far that it becomes meaningless, as in some guidance by the standards-setters, where oral indications given by a broker in an illiquid market, even in the midst of a financial turmoil, is still considered superior to any other valuation.

And, if such move towards more fair value materialised, sooner or later, it would but amplify the drawbacks of fair value accounting and its impact on the economy.

III - WHAT CAN BE DONE TO REDUCE THE PRO-CYCLICAL EFFECTS OF FAIR VALUE ACCOUNTING ?

On one hand, it seems that the problems engendered by fair value accounting are so numerous that the whole approach and body of principles underpinning the definition of new accounting standards should be suspended, reversed, or abolished. Some do think that such strategy is the only realistic and efficient, and public statements have been made in that direction.

On the other hand, the road seems narrow for alternatives to be articulated, not because it would be too burdensome or fastidious to articulate and implement, but because other problems should also be avoided. "*Historical cost*" accounting does not constitute the alternative to fair value accounting for financial instruments held for trading for example. So-called "*mark-to-model*" will not be the only solution for instruments traded in large volumes for firms using them in the normal course of their financial business

activity. Neither should accounting standards become so complex themselves that they would lose their nature of being “principles-based” and become a source of permanent legal insecurity.
In other words, the objective is to fight pro-cyclicality, not to reinvent accounting in general.

Accounting standards should remain a body of rigorous principles, reflecting the economic activity and environment of firms, instead of relying essentially and increasingly on market valuations.

1. The need for a general debate about the ways to take account of medium term economic value

- A debate should take place on the general conceptual approach. It is striking that the review of the evolution of the so-called “Conceptual Framework” of the IFRS – a common project of the IASB and FASB- does not trigger such discussions. As opposed to a mere confrontation between “historical cost” and “fair value” accounting, more interesting results could possibly be achieved around a discussion about the best ways to take account of the economic performance of a company and thus go beyond financial standards to more economic standards. Such approach is forward-looking: historical cost is not always a good measure because the past never occurs again and because excessive reliance on the present, as in the case of market value, is too volatile in many cases.

  The remaining option is to provide some sound conceptual base for accounting system destined to favour medium term business activity instead of instant market measurement.

  a) A distinction could be made between two separate types of activities:

     - those that yield a profit by combining or transforming factors of production into products whose sale value exceeds the value of factors (1).
     - those that yield a gain because the prices of the assets rise while such assets are in possession of the firm (2).
     - activity (1) uses factors, ie. combines or transforms factors and creates something different, a (new) product (ex : industrial activity as well as deposit / lending activity).
     - activity (2) consists of the purchase of a factor or an asset and its subsequent sale which (hopefully) results in a profit (ex : trading in a bank / broker).

     In the first case, the profit is derived from using production factors, and in the second case from holding factors or products. This causal relationship between what the activities consist of, using factors versus holding them, is a centrepiece of logic for a faithful representation of business activities.
     A business activity involves more resources than a balance sheet can reflect in the form of assets: human resources and combination of factors by a process. Every business activity has this inherent attribute: an economic logic, specific to each type of activity. Performance reporting should therefore reflect the actual value creation of an entity, not only measure the difference between two balance sheets.

  b) Users’ demand should be definitely better addressed in what relates to performance reporting: analysts and investors expectations are based on cash flows forecasts for purposes of using "multiple" and discounted cash flow methods. A cash flow performance reporting is more adapted to evaluation than a fair value model :
     - fair value changes do not reflect actual cash flows generated in each period of reference,
     - fair value accounting transfers pieces of performance from period to period without proper allocation of cash per period,
     - fair value accounting creates confusion by anticipating the recognition of commercial margin yet to be realised in the production cycle.

Statement of income needs to report the recurring sustainable performance based on the ability of the production cycle to generate cash flows. Comprehensive income does not address the actual needs of users and displays virtual gains which do reflect the entity performance.

Fluctuation in value of non-cash resources should be developed in footnote information in a liquidation perspective that is not inherent to the business itself that should always be considered on an ongoing basis.

<u>This would finally lead to move from “fair value accounting” to what could be named “economic accounting” or “value creation” accounting.</u>

- Beyond concepts, discussion would possibly take place over some <u>principles</u> that could be enshrined in the set of accounting rules. A number of possibilities have been cited. One would be to make reference to financial stability. Another would be to make reference to the need for <u>conservatism</u> in performance reporting, a key principle which seems now outdated in the view of standard-setters.

- A discussion could also take place about some <u>important issues</u> that need to be addressed. Among the most urgent are :
    - *accounting for derivatives* ; in that case, the usual approach once advertised by the IASB, whereby it takes account of “*substance over form*” seems to have been forgotten, as in most cases, the “dogma” to account for derivatives at market value seems to overrule whatever evidence about the context and the use intended for the said derivative ; given the sophistication of such strategies and without relinquishing vigilance in any manner, it seems no longer possible to stick to such exclusive approach ;
    - *accounting for hedging strategies*, with a view to better taking into account the real needs of firms ;
    - how to accommodate *dynamic provisioning* is also a key issue, that would need to be addressed. More generally, it is important to ensure that the present restriction to provisioning in IFRS does not prevent companies from using this process in a transparent and supervised manner.

- Finally, <u>it is hard to imagine to leave the present ambiguity about future orientations on “full fair value”</u> : if there are no such orientations, it could be easily clarified ; if there are some, this would be an issue in terms of the present work underway about pro-cyclicality and, in general, financial stability.

2. Some problems need to be fixed without delay

- Some changes have been 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”. <u>Some consistency modification should be made, as asked by the EU Commission to the IASB, as regards (i) the reclassification of assets classified under the fair value option, (ii) assets with embedded derivatives and (iii) impairment rules.</u>
These three requests illustrate respectively : (i) the need to take into consideration the business models of insurance companies, which are confronted to the same stakes as banks in that instance but struggle with different rules, it being said that accounting standards applying to the insurance sector are far from stabilised ; that illustrate the need to take better account of business models ; (ii) the need to take account of the economic nature of assets with embedded derivatives and be able to value them differently from derivatives which are ruled by too rigid principles ; (iii) the need to bring more flexibility in IFRS to take account of the economic environment in a normal manner.
The corresponding changes are expected in early December.

- A number of other changes also would be needed in order to address the pro-cyclicality effect of fair value accounting

<u>The general approach could be the following</u> :

a) only those assets which are in effect meant to be used for trading *and* are traded on an organised market, would be held in the corresponding category and marked to market; deeper work on that definition would avoid a misplaced classification for many products which were held but not traded because actually not tradable for lack of possible infrastructure for such trade to happen, for example. For those products, it is obvious from the start that the market price will not be meaningful. Such change would not mean to offer more flexibility to market players, but refine the understanding and classification of products and reduce the pro-cyclical risks ;
b) on the other hand, it would be possible to better define what is the firm's economic use of the assets, and there again avoid some misplaced classifications with pro-cyclical consequences ;
c) to a certain extent, the conditions under which changes could be made by companies could be reviewed, and possibly more options given in counterpart of some limitations
d) these objectives should be achieved without unduly creating additional and complex rules

These elements imply a number of concrete changes, including but not exclusively to : the definition of assets allowed to be taken out of the "held for trading" category ; the definition of assets allowed to be taken out of the "held to maturity" category (so-called "tainting rule") ; the need to revisit the description of the approaches to valuations (the so-called levels 1/2/3) ; some inconsistencies which should be treated, like the "own credit risk" issue, whereby a firm whose debt rating decreases can see the "fair value" of its debt decrease and its overall "fair value" increase, etc

- Another area for change could concern the link between performance accounting in the statement of income and valuation in the balance sheet.

  - A focus should be put on what is recorded in the *statement of income, which* financial analysts concentrate upon, and therefore the main conduit for procyclicality ; great care should be brought here, not to mix up elements in any type of comprehensive income with no clear economic meaning, fuelling misunderstandings, and encouraging procyclicality ;

  - It may be discussed whether it is necessar*y to r*ecord *adjustments in equity – which could be subject* to a review - as opposed to giving more information in the form of disclosure ;

  - As a general issue, the value of disclosures is essential : *had fair value accounting been achieved by disclosing mark-to-market values, possibly the market would have been as much (or as little) informed, but the undesirable effect that culminated with the "vicious circle" described above would not have occurred ;*

  - Finally, a more general review could be made about the *presentation of risk assessment*, notably sensitivity analysis or other generally accepted risk indicators. The usefulness of risk indicators to users of financial information as well as for financial stability purposes is obvious. However, one needs avoid confusing risk indicators which is dynamic information and accounting which is static. Risk information has to be reported as such. The current financial crisis shows that significant improvement is required in this area so that the risk inherent to complex financial instruments and strategies in a complex and volatile environment can be better reported in a meaningful and understandable manner to users. Considerations could be given to developing generally accepted risk principles. Reporting a balance sheet on a fair value basis will not provide the required information.

    It is important to note that, contrary to a statement often made, there is no link between transparency, quantity and quality of disclosure on one hand, and fair value accounting on the other. The latter would rather lead to less disclosure progressively, as all information would be supposed to be included in the market valuations. IFRS have fostered improvements in transparency for other reasons, due to the more recent and market oriented nature of this set of standards; this is positive and welcome, but does not interfere with the need to amend the substance of the fair value approach, which is a different question.

3. The combination of accounting and prudential standards is a key issue

From a financial stability - as well as practical - standpoint, there is high value in ensuring accounting standards are not so specific – as is the case if mark-to-market is the only measure of value – that they cannot be used by any of the relevant concerned parties, whose conduct on the market and in the economy would become increasingly inconsistent, at times when we need, to the contrary, more coherence in approach.

That means the possibility to use fair value accounting standards, without having to make so many calculations that the accounts do not bring direct usable information; for example:

- employees should understand the accounts directly and recognise the business model of their firm
- same for investors expecting a long term measure of the value of the firm
- managers, i.e. CEOs and CFOs need to understand and recognise in their accounts their business models, strategic choices and performance
- regulators and supervisors need to be able to use the accounts without to have to depart to much from the raw information that they contain.

As regards prudential supervision, the stakes are obviously higher.
Indeed, the objectives of accounting and prudential supervision are separate. It is justified for supervisors to add filters to accounting, in order to obtain the exact information indicators that they need.
Yet they use the same accounts. If too many filters have to be used, it will be at the expense of consistency and, which is worse, of the perception of consistency by all actors – managers, market participants, and regulators themselves.

Furthermore, a key difference today between accounting and prudential is that transparency is given on the accounts obviously, whereas publicity of prudential information is not ensured so far (it is a subject for Pillar 3 of Basel 2). Too great a discrepancy between the two approaches will be immediately felt by the market and lead to opacity overall. This could lead to recognising the need to disclose separately the two sets of information. Going to the extreme, this could render one of them useless; it is possible that the general accounts would be considered less relevant than prudential accounts because of the obligations attached to them: in that case, fair value accounting, for example, would have led to establishing perfectly satisfactory accounts, from a principle standpoint, costly to establish, but that no one would use anymore. Whatever consequences are, this would create confusion and risks.

That approach, from a practical as well as fundamental point of view, shows that accounting standards, as well as prudential standards, have a shared, yet autonomous role in the transmission of procyclicality. No doubt that a more refined "anti-cyclical" prudential approach will be a powerful tool to better managed the cycle in the future. And non pro-cyclical accounting standards would not suffice to achieve that objective, if prudential policies were not adjusted, too. The same objective, however, would not either be reached by an active "anti-cyclical" prudential policy without accounting standard made less pro-cyclical.

In the end, it appears that, in case of divergence between the two approaches, the market would be confused, to various degrees according to the size of the "gap", and left to its own guesses about facts and information that should be consistently disclosed. And that would increase its sensitivity to rumours of all sorts, and install a typical pro-cyclical type of "herd" behaviour, which is precisely meant to be avoided.

The best answer to these risks is to ensure a "macro-prudential" approach including accounting standards, i.e. ensuring consistency between them and prudential standards at all times: this is why some consequences have to be drawn on the institutional field.

IV - WHICH PROCESSES COULD ENSURE A DURABLE CONSISTENCY BETWEEN ACCOUTING STANDARD-SETTING AND FINANCIAL STABILITY ?

1. A reform process of the IASCF ("International Accounting Standard Council Foundation"), the « mother-institution » of Trustees of the IASB ("International Accounting Standard Board") is underway; the ECOFIN Council has called for a reform of the IASB for years, and could finally ask for implementation of a first set of reforms in July 2008. Since then:

- the Trustees have not yet taken into account the requests of the ECOFIN, and the European Commission has not reacted at this stage, in expectation of the present debates over the reform ; it must be recalled that the reform consisted in creating a "Monitoring Group", which would be the main change offered to public authorities. The status of central banks is not very clear in the process, although financial stability is at stake, combination with prudential rules is key and they remain lenders of last resort ;

- the orientation of such reform can only be to try and change the attitude – as a need, described by the G20, that emerges as a lesson of the turmoil - of standard-setters and regulators not taking sufficiently into account, like market participants themselves, the general economic environment ; now the objective is to ensure that such situation will not occur again, notably as regards the necessary consistency between accounting and prudential standards, based on the analysis presented above, and in terms of accountability vis-à-vis public authorities ; the better the system is organised, the better the independence of the standard-setter will be preserved ;

- **independence of standard-setters should be framed by the involvement of public authorities in the conceptual choices which support the choice of accounting systems**: accounting is not a scientific nor a technical or neutral matter. Public authorities cannot discharge themselves from making the conceptual choices which are crucial when it comes to define accounting rules.

2. Against this background, the current reform project needs to be bettered significantly; lessons learnt in the past years must be drawn, thus combining the preservation of the benefits of all kind brought by the IFRS, the need to improve significantly the channels of communication between authorities and the standard-setter, and to devise an organisation meant to ensure the efficiency of a global standard setter. Given the global risks at stake for financial stability, continued recourse to the IFRS can only be envisaged if these objectives are met in practice**.**

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The analysis and proposals made here constitute a set of orientations which, combined, could lead to a framework where *fair value accounting* is used when relevant, i.e. avoiding as much as possible to add procyclicality and *standard-setting process* is further improved, in order to ensure that they durably contribute to financial stability.