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Report of the Conference
“Fair value or an Alternative Measurement Model: What is Fit for Purpose
in both the Current Financial Turmoil and the Long Term?”

Brussels, July 8, 2008

Accounting standards have been historically treated as technical issues to be dealt with among specialists, and discussions about them have been largely confined to restricted policymaking and academic circles. However, in the last 15 years the issue has become increasingly politicised. In particular, critics have pointed to mark-to-market accounting practices as instrumental in exacerbating the business cycle by inflating or deflating assets during market swings and to the difficulty of operationalising what constitute a “fair” value. Others point to fair value as the best mechanism to report economic realities and argue that there are no better alternatives.

Against this background, the European Capital Markets Institute and the Institute of Chartered Accountants in England and Wales (ICAEW) jointly organized a conference about fair value accounting that took place on Tuesday July 8, 2008 in order to contribute to the debate and to highlight future options. Invited speakers were Mark Rhys, Ulf Linder, Paul de Grauwe, Fernando Restoy and Philippe Danjou. Overall the conference raised many questions about fair value accounting: more debate and research is needed to settle several issues pertaining to accounting standards.

Mark Rhys, Chairman of the Financial Services Faculty of the ICAEW, introduced issues and hurdles fair value accounting must confront. He presented the ICAEW Measurement in Financial Services paper, which represents a contribution to this debate. The issues paper broadly argues that consistency in the basis of measurement across all assets being measured and across all uses and users is unlikely to be successful. It calls for a mixed model approach for the financial services industry to provide more useful information for different audiences. In determining the most appropriate basis of measurement – such as historical cost or fair value – institutions need to take into account various factors, including the purpose of financial information and the business model of financial institutions. The basis for the measurement of assets will vary according to institutions’ business model: accrual accounting might be appropriate for a commercial bank, whereas mark-to-market might be more suitable to an investment bank.

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Mr. Rhys claimed that mark-to-market assumes liquid markets, and when liquidity dries up these rules may not be appropriate because market prices do not reflect fundamental information about risk. He also argued that the real difficulty lies not in these more simple cases, but in the edges between short and long term activity and where hedging activity is undertaken. Rhys concluded saying that full disclosure is crucial to let users understand underlying assumptions of accounting principles.

Ulf Linder, Deputy Head of the Accounting Unit at the Directorate General Internal Market and Services of the European Commission, presented the regulatory issues pertaining to fair value accounting. He emphasized the increasingly politicized nature of accounting standards. Mr. Linder defended fair value saying that it got blamed to be the messenger for bad news but added that accounting standard were not the prime responsible of the crisis. Given that companies and shareholders need precise and updated information that reflects economic reality, Mr. Linder argued that there seems to be no clear alternative to fair value accounting. He claimed that European accounting standards have stood reasonably well the test of the subprime crisis, even though there is certainly room for improvement. Mr. Linder repeatedly stressed the importance of working in international fora such as the Financial Stability Forum in order to apply globally consistent rules. He also added that the European Commission found no evidence that fair value accounting aggravated the economic cycle. In his view, the questions for the future debate relate to when and how should fair value be applied, rather than whether it should be replaced or not applied. Mr. Linder concluded arguing that alternative models of accounting decrease market transparency, thereby reducing market confidence in the reliability of data.

Paul de Grauwe, Professor of Economics at University of Leuven, focused on the link between mark-to-market accounting and the efficient market hypothesis. Mr De Grauwe strongly criticised the efficient market hypothesis arguing that prices may fall prey to speculative frenzies leading to excessive volatility. He cited the “dot.com crash” and massive changes in the S&P500 index during the period August 2006-August 2007 to demonstrate the irrationality of market forces. Assuming market prices reflect fundamental information about assets, mark to market relies on faulty data. Therefore fair value exacerbates the business cycle by intensifying the sense of euphoria in market upswings while depressing prices during downturns, Mr. de Grauwe claimed. Mr. de Grauwe concluded saying that mark to market show excessive confidence in the efficiency of financial markets, and advocated for measures to introduce inertia in market prices.

Fernando Restoy, Executive Board Member of the Securities Exchange Commission of Spain (CNMV) and Chairman of CESR-Fin of the Committee of European Securities Regulators, defended fair value as a big achievement. He said it makes financial statements more comparable and it gives a more coherent approach to accounting. Mr. Restoy argued that there are technical difficulties to compare financial and non-financial assets when using fair value accounting. He expressed concern at the lack of conceptual agreement on what constitute “fair value,” and said there should be limits to restrain excessive volatility in financial statements. Fair value may be pro-cyclical, but it also

discourages risk-taking by promptly devaluing risky assets, Mr. Restoy claimed. Moreover, he added that market practices such as margin calls and stop-loss strategies rather than fair value should be blamed for increased volatility. Mr. Restoy demanded further clarification on how to give a fair value to illiquid instruments and called for further disclosure of valuation techniques. He concluded by stating that financial information is not a prudential policy tool. Mr. Restoy also made reference to the CESR consultation on a statement on fair value measurement and related disclosures of financial instruments in illiquid markets (published on 10 July).

Philippe Danjou, Director of France's Authority on Financial Markets (AMF) and Member of the International Accounting Standard Board (IASB), emphasized the usefulness of having public discussions on issues as important as accounting standards. He stressed the need for simplicity, and fair value represented a clear step in that direction. Mr. Danjou recognised that there is no definition on what exactly constitutes fair value (he asked whether it means market prices, exit prices, entry prices or if it is the result of a model). He said he is convinced fair value is not always the market price of an asset, and solutions should be found to reflect this concern. Mr. Danjou made reference to various ongoing work streams at the IASB such as the Fair Value Measurement project (including the creation of an expert advisory panel to look at the application of fair value in illiquid markets), the revision of IFRS 7 on the disclosure of financial instruments and the projects on consolidation and derecognition. He admitted that there has been dissatisfaction with IAS 39 and that the IASB is looking into the matter, but reiterated that adding options would increase its complexity. He welcomed the ICAEW Measurement in Financial Services paper as a useful contribution to the debate.

The debate that followed panelists' interventions mainly focused on two topics. Firstly, there was disagreement amongst panelists on whether market prices were useful in defining a fair valuation of assets. No real alternative emerged, given the difficulty of reflecting market fundamentals and of defining exactly such concepts. Secondly, a question from the public raised the question of accountability and democratic control of unelected bureaucrats and technicians. Because of the complexity and the high technical level of accounting standard, the vast majority of the population was left out of discussions having immediate consequences on their lives. A few panelists mentioned the politicization of the topic as having positive repercussions on democratic control.

Piero Cinquegrana