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FAIR VALUE ACCOUNTING IS THE WRONG SCAPEGOAT FOR THIS CRISIS

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NICOLAS VÉRON

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The ongoing financial crisis has spurred much finger-pointing at fair value accounting for financial instruments, as set out in both leading sets of accounting standards used by listed companies around the world, namely US Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS). Prominent financial leaders such as Martin Sullivan, CEO of AIG, and Henri de Castries, CEO of AXA, have singled out fair value and the related wide use of mark-to-market accounting as a major factor in the crisis[1]. Echoing these views, European Commissioner Charlie McCreevy expressed his concern on 1 April this year about the 'impact of mark to market valuation when markets generally become illiquid and irrational'[2].

On closer inspection, there is not just one

panic, especially because of information asymmetries and differences among market participants in terms of beliefs and behaviour. By granting too much relevance to markets, accounting standards would thus be culprits of accentuating both booms and busts. This criticism questions fair value accounting not only when applied to illiquid securities, but also in much more general terms as the guiding principle for accounting recognition of a broad range of financial instruments[4].

The difficulties to which these criticisms refer are real enough. But the policy conclusion they draw, namely that current standards should be temporarily or permanently amended in order to restrict the scope of fair value accounting, remains unconvincing, for at least three reasons. It does not provide any credible alternatives to the standards currently in force. It disregards the negative impact which would result from the loss of data presently supplied by financial reporting in compliance with these standards. And it unhelpfully muddies the distinction between accounting and prudential concerns, which correspond to different objectives and should be more carefully distinguished.

Critics are at a loss to accompany their arguments

extreme cases, mark-to-model degenerates into what I would call mark-to-myth'[7]. For investors, reference to an actual market transaction, even an imperfect one, is preferable in principle to an internal model elaborated by the issuer.

Other proposals have been tabled to cushion the accounting shock resulting from the market turmoil for financial firms, but none win the day. In a comment piece published on 3 April 2008 in the *Financial Times*, three members of the Technical Expert Group of the European Financial Reporting Advisory Group (EFRAG[8]), all employees or former employees of large listed companies (Bear Stearns, BP and Siemens respectively), proposed a mechanism for smoothing market prices over a period of six months to one year to serve as a yardstick for writing down financial assets[9]. But this proposal, which would dampen the information content of financial statements by making them less responsive to market movements, would not necessarily help to achieve the objective sought by its authors. In the specific case which has focused debate, the use of the ABX indices as a price reference for mortgage-backed securities, it would arguably not have significantly improved the lot of banks. As of late April 2008, and in spite of a recent rebound, the value of these indices has remained depressed for more than six months, and an average over this period would still produce an 'artificially low' value compared with what critics of fair value deem 'economic fundamentals'[10].

While the alternatives to fair value do not throw up any obvious answers to the immediate needs, they do on the other hand have a potentially harmful feature in common. These proposals reduce the information available to investors and other users of financial information, and in many cases provide firms with tools to 'manage earnings' and to skew reporting in a way which fair value accounting, even hit by the drying up of liquidity, does not permit or at least not to the same degree. Thus, if such proposals were to be adopted, they would most likely entail a higher risk premium for shares generally, and weaker market performance. This effect was observed in spectacular fashion in 1990s Japan, when the ministry of finance allowed banks to avoid depreciating assets whose value had been reduced as a result of market depression. The upshot was an across-the-board loss of confidence in banks' financial reporting, which most observers today think helped to exacerbate the financial crisis rather than attenuate it.

Moreover, the fear associated with a possible overprovisioning of losses due to fair value accounting under unusual market conditions is at best only marginally based on empirical observation of market behaviour. Over the last few months, markets have on occasions shown remarkable resilience to the announcement of sometimes spectacular accounting losses on the part of banks. In a particularly noteworthy case, the disclosure by UBS of a $19 billion write-down in the first quarter of 2008, on 1 April, led to an upsurge of around 15% in the share price compared with the closing price of the previous day, which was maintained over subsequent trading days. By contrast, episodes where the market abruptly lost confidence in a financial firm, for example in Bear Stearns on 13 and 14 March 2008, were not associated with new accounting disclosures but with more fundamental fears about intrinsic liquidity and solvency. In other words, markets do not appear to be blinded by 'artificial' features of accounting data. The problems encountered are real and relate to dysfunction of the market itself, rather than to the way in which the market is reported through accounting.

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[7] Warren Buffett, *Letter to shareholders*, included in the annual report of Berkshire Hathaway Inc. for 2003.

[8] EFRAG is a private organisation consulted by the European Commission before taking its decisions on the adoption of the IFRS accounting standards.

[9] Carsten Zielke, Michael Starkie and Thomas Seeberg, 'Reporting move could break the writedown spiral', *Financial Times*, 3 April 2008

[10] The chairmen of EFRAG and of its Technical Expert Group publicly distanced themselves from the three experts' proposal: Göran Tidström and Stig Enevoldsen, 'No view formed on the credit crunch', *Financial Times*, 14 April 2008

At the end of the day, fair value accounting as currently prescribed by IFRS and US GAAP standards can be described in analogy with Churchill's portrayal of democracy, as the worst

Moreover, accounting information, including all disclosures mandated by the standards, is only one part of the financial information supplied by financial services companies. As the