Policy Briefing

Fair value accounting and the financial crisis

Don’t shoot the messenger

1. Introduction

To blame fair value accounting for the current difficulties being experienced across the capital markets is to ‘shoot the messenger’ at a point in time where transparency of financial information – no matter how painful the economic reality – will be a key ingredient in helping to restore economic confidence.

The ICAEW believes that, while fair value is not appropriate in all cases, existing requirements for certain financial instruments to be measured according to this standard are there for good reason and reflect the relative weakness of historical cost accounting, the main alternative, for these particular items.

2. Criticisms of fair value: pro-cyclicality

Fair value recognises changes in market prices of assets and liabilities immediately. This effect is particularly important for banks as their ability to lend depends on the maintenance of appropriate balance sheet ratios. Any change in the net assets of a bank is likely to be magnified in its ability to provide credit to other businesses and to individuals. As this can encourage banks to lend more in good times and lend less in bad times - leading to higher profits (and stronger balance sheets) in the good market conditions and probably to higher losses (and weaker balance sheets) in the poor market conditions - fair value is said to be pro-cyclical in its knock-on impact, through lending, on the wider economy, ie, it multiplies the effects of the business cycle. The way that fair value interacts with regulatory capital rules is also said to be pro-cyclical. The capital rules can force banks to sell assets in a downturn, which is said to depress asset prices further.

At the extreme, fair value in a downturn may make a business appear bankrupt when - it is argued - this is merely a reflection of temporarily depressed markets. An opposite kind of argument might apply when there is a bubble in market prices.

3. ICAEW position on fair value accounting and the financial crisis

The ICAEW does not believe that fair value in particular or financial reporting in general has been the cause of the credit crunch or the worsening financial crisis that we have experienced from September 2008. Moreover, we believe that it would be entirely wrong to abandon the current use of fair value accounting as applied to financial instruments.

In its current – limited – use, fair value and the financial reporting disclosures associated with it have brought the challenges facing major financial institutions to the attention of all those in the financial reporting chain earlier than would have been the case under alternative reporting models. In the longer term, we believe that maintaining this transparency of financial information will be key to restoring financial confidence.
The widely commented example of the Japanese financial crisis in the 1990s, characterised by financial institutions’ failure to report the extent of their non-performing loans and subsequent slow economic recovery, arguably shows how not facing up to the scale of such problems as soon as possible can make their resolution more prolonged and more painful. Fair value is more likely to lead to a realistic assessment of current problems, enabling them to be addressed more speedily and effectively than might otherwise be the case.

4. ICAEW position on the pro-cyclicality of fair value

An argument for the temporary suspension of fair value is that market prices are, at present, unduly depressed and therefore lead to unrealistically low asset values. While in some ways it would be comforting to think that prices of many assets are currently unduly depressed, we believe that it is very difficult to say this with any satisfactory degree of confidence, without the benefit of hindsight. In the current market turmoil, the best available estimates of value for the appropriate instruments – where markets exist – will be the market price.

5. Background: Fair value and historical cost

Accounting standard-setters have defined fair value in different ways. All of them are essentially variations on current market value or an estimate, where a market value is unavailable or regarded as unreliable, of what the market value would be if there were a market. Fair value is also referred to as mark-to-market. There are various alternatives to fair value as a basis of measurement in accounts. The principal one, and in the context of the current debate the only one seriously considered as an alternative, is ‘historical cost’.

There are two major differences between fair value accounting and historical cost accounting:

- Fair value recognises unrealised gains, whereas historical cost only recognises realised gains – ie, gains that arise when assets are sold. That is to say, fair value accounting recognises gains where assets rise in value above their historical cost.
- When assets fall in value, this is recognised under both fair value and historical cost accounting. But whereas fair value means the assets are written down to their new fair value, historical cost means that an impairment provision is made against those assets.

Where asset values have fallen, both fair value and historical cost require them to be written down. Under historical cost accounting, the impairment provisions are based on the management estimate of net losses that have occurred at the date of assessment (ie, at the year end). Under fair value, the market will set prices based on their expectations of both current and future gains and losses. Historical cost valuations may therefore provide a higher valuation than market values because they do not take account of expected future losses, which the market would take into account and which would therefore be reflected in fair value.

When calculating the extent of write downs there is a risk under fair value that prices from ‘unduly depressed’ markets will be reflected in the accounts. Under historical cost there is a risk that the accounts will reflect undue managerial optimism. We would point out, however, that since the start of the current crisis in 2007, optimistic statements from the managers of a number of financial institutions have not been borne out by subsequent experience.

6. Current use of fair value

In financial reporting, different ways of measuring items have different benefits and shortcomings. At present, the use of fair value in financial reporting is limited. Its principal application is to derivative financial instruments and financial instruments held for trading largely because of the perceived defects of ‘historical cost’, the principal alternative to ‘fair value’, for these items.
Financial instruments currently required to be reported at fair value may have a historical cost of zero (e.g., interest rate swaps and forward foreign exchange contracts) or have a very small cost compared to the potential cash flows under the contracts. Under historical cost accounting, these derivatives were often off-balance sheet. Fair value accounting brought them on to the balance sheet. There is a widespread view, which we share, that reporting these items at historical cost is uninformative. For such items, even a subjective fair value measurement is likely to provide a better measure of business performance and balance sheet strength than historical cost.

7. Further inquiry

The ICAEW – through its Financial Reporting Faculty - is committed to continual review of the appropriateness of financial reporting requirements. Issues that should now be examined include:

- The difficulties of using fair value in illiquid markets, and possible solutions.
- An analysis of how deep any pro-cyclical effects of fair value accounting are.
- Whether further refinements to standards or guidance are appropriate.
- Whether pro-cyclical effects can be countered by capital adequacy regulatory action.

The ICAEW will continue to contribute to the assessment of these issues by the US Financial Accounting Standards Board and the International Accounting Standards Board, and to the forthcoming major review by the two Boards of measurement issues generally.

8. Treasury Committee ‘Accountancy and the banking crisis’ hearing

On 11 November, the UK Treasury Committee heard evidence on ‘the role of Accountancy and the banking crisis’. The committee set out to scrutinise the “The role that fair value accounting has played in the banking crisis, and whether any change to fair value reporting rules and requirements is appropriate.”

Evidence was taken from Paul Chisnall, Executive Director of Financial Policy & Operations, British Bankers’ Association; Russell Picot, Member, BBA Financial Reporting Advisory Panel; Stephen Haddrill, Director General, Association of British Insurers; Liz Murrall, Director, Investment Management Association; Charles Cronin, Head, Chartered Financial Analyst Institute Centre; in addition to Michael Izza, Chief Executive of the ICAEW.

Then following is taken from the UK Treasury Committee transcript from the hearing:

“Q148 John Thurso: Can I ask each of you this question for a reasonably quick answer, if I may: why is fair value a better method of accounting for financial instruments than amortised cost?

Mr Haddrill: Simply because it is the best reflection you can get of the value at the time rather than the value at the point at which the asset was acquired.

Mr Picot: It is if you are trading, but it is not if your intention is to hold them long-term.

Ms Murrall: Historic cost is an arbitrary point in time. If you record assets at historic cost, accounts will not be comparable.

Mr Cronin: An historical cost is a rear-view mirror exercise. It is also subject to the management judgment of when you put a write-down in or not, whereas fair value gives you an instant appraisal of what is going on from the collection of the market and an unbiased market.

…

“Mr Izza: [P]ainful though fair value may be, it has got the news out much faster than other methodologies might have done, leading to speedier actions to deal with the situation. It is very important that we do not seek to shoot the messenger, in these circumstances.
9. About the ICAEW

The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 132,000 members. Three thousand new members qualify each year. Our membership includes Financial Directors and Chief Executives across all sectors of the UK economy, from large multinationals to SMEs, including micro businesses.

The ICAEW Financial Reporting Faculty was launched in December 2008. An online community of financial reporting professionals, it is open to ICAEW members and non-members alike, and provides a range of services as well as an international platform for the exchange of ideas on current financial reporting issues. For more details please see [www.icaew.com/frf](http://www.icaew.com/frf).

FURTHER INFORMATION
Please contact the ICAEW if you require any further information:

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<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>ICAEW</th>
<th>T:</th>
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<tbody>
<tr>
<td>Dr Nigel Sleigh-Johnson ACA</td>
<td>Head of Financial Reporting Faculty</td>
<td>ICAEW</td>
<td>+44 (0)20 7920 8793</td>
<td><a href="mailto:Nigel.Sleigh-johnson@icaew.com">Nigel.Sleigh-johnson@icaew.com</a></td>
</tr>
<tr>
<td>Iain Coke ACA</td>
<td>Head of Financial Services Faculty</td>
<td>ICAEW</td>
<td>+44 (0)20 7920 8674</td>
<td><a href="mailto:Iain.Coke@icaew.com">Iain.Coke@icaew.com</a></td>
</tr>
<tr>
<td>Nick Maxwell</td>
<td>Public Policy Manager</td>
<td>ICAEW</td>
<td>+44 (0)20 7920 8617</td>
<td><a href="mailto:Nick.Maxwell@icaew.com">Nick.Maxwell@icaew.com</a></td>
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