Shooting the messenger?

- My cholesterol is too high
  - Should I blame
    - my past diet?
    - the blood test?

- There is a global financial crisis
  - Should I blame
    - past economic decision making?
    - fair value accounting?
Fair Value Accounting

- **In THEORY**
  - Recognition and Disclosure
  - Financial Position and Performance
  - Relevance and Reliability

- **In PRACTICE**
  - Prescribed
  - Applied
  - Used
Fair Value Accounting - theory

- RECOGNITION and/or DISCLOSURE
  - Disclosure is not an adequate substitute for recognition
    - Experience with share-based payments in the US (SFAS 123)
  - Recognition should be supplemented by disclosures
Fair Value Accounting - theory

- RECOGNITION
  - Financial Position and Performance
  - Tension between RELEVANCE and RELIABILITY
Fair Value Accounting - theory

- RELEVANT information
  - Reflects economic reality (IMF GFS Manual 2001)
  - Measures identical investments at the same amount
  - Provides input to sell, hold or buy decisions
    - Need to know current values
    - An expectation/hope of future price increases is no reason to ignore current low prices
    - Fluctuations in prices have information content
  - Value-in-exchange vs Value-in-use
Fair Value Accounting - theory

- RELIABILITY (faithful representation)
  - Ideally there would be active markets
  - If not, there is a measurement hierarchy
    - SFAS 157
    - IMF GFS Manual 2001
  - Estimates and professional judgement are an integral part of accounting
Fair Value Accounting - theory

- FINANCIAL PERFORMANCE
  - Recognition of changes in fair values
    - Volatility vs smoothing
    - Economic reality vs management discretion
  - Benefits for the public sector
    - Current cost of services
    - Sustainability
Fair Value Accounting - practice

- An argument used against fair value accounting
  - “… banks would become more conservative in their lending decisions involving nonprime borrowers”
  - Is that such a bad thing?
Fair Value Accounting - practice

- Fair value accounting and the global crisis
  - How fair value accounting was PRESCRIBED
    - Categories with different treatments
    - Guidance where active markets suddenly become inactive
    - Independence of standard setters
    - Level playing field
      - US GAAP generally permits/requires less fair value accounting than IFRSs
  - Fair value accounting as prescribed can be, and is being, improved
Fair Value Accounting - practice

- Fair value accounting and the global crisis
  - How fair value accounting was APPLIED/AUDITED
    - Measurements were wrong, left too high for too long
    - Frequency/timeliness of reporting
  - Fair value accounting was not always applied in the way it was intended
Fair Value Accounting - practice

- Fair value accounting and the global crisis
  - How fair value accounting was USED
    - Input for users’ decision-making
    - Accounting information should be read in the context of the market conditions that exist at the time the information is prepared, as well as at the time the information is being used
  - Fair value accounting was not always used in the way it was intended
Fair Value Accounting - practice

- Many USERS support fair value accounting
  - CFA Institute
  - Economists
    - European system of accounts (ESA95)/ESA95 manual of government deficit and debt

- Some PREPARERS support fair value accounting

- POST-MORTEM findings
  - SEC research
Conclusion

- Fair value accounting can provide
  - relevant and reliable information, about
  - financial position and performance, through
  - recognition supplemented by disclosures, if
  - it is prescribed, applied/audited and used properly.

- This can happen, if supported by
  - global independent standard setters, issuing
  - comprehensive standards/guidance, applied using
  - professional judgement, with a clear understanding of
  - the objectives of financial statements and prevailing market conditions.