Can Accounting Standards Save the Banks?

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The criticism has been so often heard recently that it could be mistaken for a consensus view.

Fair value accounting, so the argument goes, is a prime cause of the financial crisis. ('Fair value' refers to a directly or indirectly observable market price, or to the result of a financial model if no relevant market transaction can be observed.)

It is alleged to have a pro-cyclical effect that inflates bubbles on the way up and adds to panic on the way down. For illiquid assets, 'mark-to-market' accounting is accused of leading to aberrant bookings, making banks' balance sheets look worse than they actually are, and forcing distressed sales of assets at artificially low prices.

But however frequently expressed, this criticism is misleading.

The general argument about pro-cyclicality may fit a prudential framework but is ill-suited to accounting. When a financial instrument is traded on a deep and liquid market, instant transaction prices are the best available value signal. If Microsoft shares sell for $30 today against $35 three months ago, it makes little sense to book them at $35.

Alternative methods would fail to adequately serve the purpose that a broad consensus assigns to accounting standards: provide investors with relevant, reliable, comparable and understandable information to best help them make investment decisions.

The other aspect of the fair value critique is specifically about illiquid assets. No doubt these pose a tricky problem to accountants. Whatever method is used, any value is debatable when markets have dried up.

But 'artificially depressed' fair values merely reflect investors' present mistrust vis-à-vis the corresponding asset classes. Nothing suggests at this stage that the way they are measured adds specific perverse effects to the market turmoil.

Look at the downward spiral episodes since the start of the crisis, including the one that brought down Bear Stearns around mid-March: none is directly linked to the release of accounting data. It is the market itself which is out of kilter, not the accounting yardstick.

Accounting losses are accepted by the marketplace when companies face up to them and explain. Evidence is the remarkable 15% hike in UBS shares upon its announcement of a USD19 billion write-down on 1 April.

Conversely, there can be no doubt that reducing accounting transparency, whether by reverting to historical cost or by authorising banks not to reflect market developments in their financial statements, would hurt the market and have negative consequences. This was illustrated by the 1990s Japanese crisis, when the opaque accounts of banks fed the general mistrust.

In a nutshell, fair value accounting may not be satisfactory, but the alternatives are worse. Pending the return of liquidity, investors prefer to view the world through the fuzzy lens of fair value, rather than being left to complete corporate discretion or have information which only reflects an outdated past.

That said, several aspects of the financial information system need to be revisited.

In contrast to accounting standards, amendments are overdue to prudential rules such as Basel II, under which supervisors assess the capital strength of banks. Better account needs to be taken of the effects of long market cycles, in order to avoid banks becoming undercapitalised in the event of a downturn.

Accounting standards themselves warrant clarification on several points. More importantly still, they need to be implemented with rigour and consistency, which is not yet the case at the moment in Europe. Clear guidance is needed on how to implement them, a point the Financial Stability Forum aptly made in its report submitted to the G7 finance ministers at the beginning of April. This especially applies to disclosures which are vital to understand the many assumptions underpinning financial statements and to assess possible measurement bias.

Beyond this, public information on financial risks should be considerably improved, in a context where credit ratings have become less useful than they used to be.

The current accounting debate does not reflect a Manichean struggle between theoreticians and practitioners, or between Anglo-Saxons and continental Europeans. It rather betrays a general inability to prepare, audit and use appropriate information on financial risks.

In this difficult context, and in light of the experience of past crises, the interest of the financial system as a whole suggests that investors have the fullest information, in spite of inevitable measurement imperfections, and even if this causes banks to suffer some pain.

From this angle, and provided they are rigorously implemented, current standards on fair value accounting do not perform their role so badly after all.

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