Accounting

Shining a light on company accounts

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"Fair value" accounting for all financial assets and liabilities is on its way. Banks and companies hate the idea

THE bodies that lay out the rules on how firms must prepare their accounts are getting ready for a bruiser of a battle. Standard-setters in America and Britain believe ever more strongly in the principle that companies should "mark to market" all financial assets and liabilities—that is, record them at their current market value, rather than at historical cost, as happens now. It would entail sweeping changes to accounting. Over our dead bodies, reply plenty of big banks and companies.

The crusade for fair value began in earnest in 1997, when accounting bodies from America, Australia, Britain, Canada and New Zealand set up a working group to develop a proposal for international accounting standards on fair value. Last December the working group published its report and invited comments. The next step is for standard-setters to agree on, and enforce, fair-value rules. In a few years' time, companies may be obliged to transform the way in which they report their results.

For the accounting authorities, it is far more useful to measure assets and liabilities at fair value than at historic cost. It is also a chance, they feel, for the accounting profession to catch up with changes in the real world. Financial markets have become more volatile, meaning that asset and liability values constantly change. At the same time, financial markets have become more sophisticated, so that, usefully for fair-value proponents, prices are readily available for more financial assets than ever before.

Growth in the use of derivatives is part of the fair-value challenge. For years, derivatives contracts were kept "off-balance-sheet". Now, according to new rules from the International Accounting Standards Board (IASB), among others, derivatives must be marked to market and changes in those that are held for trading purposes put through the profit-and-loss account. But this compromise—applying fair value to some financial assets, such as derivatives, and not to others, for instance, bank loans—has created a mess, according to accounting regulators. Too many companies are finding ways to manipulate their reported results. The solution, the regulators believe, is to press bravely ahead and impose fair-value rules for all financial instruments.

Banks are horrified at the idea, chiefly because it will introduce more volatility into their earnings. That, in turn, could damage the price-earnings multiple that investors are willing to pay for their shares, raising banks' cost of capital.

In a mark-to-market system, the value of loans would fluctuate according to changes in interest rates. And banks would be forced to write down loans at once should the market judge their credit quality to be impaired. Worst of all, from the banks' point of view, these swings would have to be recognised in the profit-and-loss account for the year. France's biggest banks say that fair-value accounting would threaten the stability of entire banking systems. British banks argue that their role as providers of long-term finance to sectors with changeable credit ratings might be compromised.

Companies dislike the notion of fair value for similar reasons. The working group's proposal forbids the current practice of carrying forward gains and losses on hedges into the period of the transaction that they are designed to offset. At present, hedgers are allowed to match the transactions in one year, meaning smoother earnings. Taking away that ability, corporate treasurers say, might have the perverse effect of discouraging risk management.

Banks and corporations can be expected to resist a change that would present their earnings in a less flattering light. But another of their objections carries greater weight with the accounting authorities. In the case of many financial assets and liabilities, assigning a fair value would be a tricky—and certainly subjective—process. Portfolios of shares are easy enough to value, as are loans that trade on a secondary loan market. Yet loans that are not actively traded account for some 60% of British banks' balance sheets, for instance, according to a Bank of England paper on fair value. Lending to smaller companies would be particularly hard to gauge. And how should demand deposits be valued, considering that banks do not know their maturity?

When judging fair values, therefore, auditors will need to rely to some extent on companies' and banks' internal models and estimates. In other words, instead of manipulating loan-loss provisions, or gains and losses on derivatives, banks and companies might be tempted simply to change their internal assumptions as a way to smooth earnings. Companies will always “massage” their earnings, an accounting regulator admits. “All we would probably be doing is shifting the places where people do it.”

Banking supervisors, for their part, sound warnings about fair value. The Basle committee on banking supervision last year complained that last-minute changes to the IASB's new rule on derivatives was rushed through without consulting the banks. The potential for greater volatility of earnings also worries regulators. They fear that fair value would lead to more frequent dips in banks' capital levels. The Bank of England points out that, in Denmark, which brought in an accounting system akin to fair value some years ago, one result has been that the volatility of banks' capital ratios has risen sharply. Yet volatility is real, the advocates of fair value reply, and dangerous if hidden.

David Tweedie, the head of the IASB, hopes that applying fair value to financial assets and liabilities will sharpen companies' attention to what they are doing with derivatives and other complex financial instruments. (He gives a warning, though, that moving to fair values could cause problems about how to display them in companies' profit-and-loss accounts: those need to be solved.) Supporters even hope, ambitiously, that fair value could throw up early signs of potential banking crises, as well as hasten their end. The savings-and-loans mess in America, for instance, was prolonged by easy accounting rules that allowed overly optimistic estimates of the industry's solvency.

Apostles of fair value will need to tread carefully if they are to realise their vision internationally. For a start, they need to make sure that their movement, started by five English-speaking countries, does not in future look as Anglo-Saxon in character as it does right now. Although the European Commission has decided that companies in the euro zone must report in line with IASB standards by 2005, Europe will still have the power to reject individual standards, including any on fair value. That would be a mistake. Gradually introduced and carefully explained, fair-value accounting should make for a more transparent and sound financial system.