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Fair Value Accounting is the Wrong Scapegoat for this Crisis

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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 the US Generally Accepted Accounting Principles (US GAAP) and the International Financial Reporting Standards (IFRS). Prominent financial leaders such as Martin Sullivan, former 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 (see Hughes and Tett, 2008). 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' (McCreevy, 2008).

On closer inspection, there is not just one criticism of fair value accounting, but two, centring respectively on illiquidity and procyclicality. The illiquidity criticism focuses on complex products resulting from securitisation of assets such as mortgage loans, which are at the core of the current financial crisis. Both IFRS and US GAAP define the fair value of financial instruments under a three-level framework: it is set as the observable market price of the instrument, or (absent the former) the observable market price of a similar item, or (if none of the previous two can be found) the result of a financial valuation model. The illiquidity criticism notes that market conditions of many complex financial instruments since August 2007 are marked by an imbalance between supply and demand, which means that market prices are rendered abnormal by the evaporation of liquidity and may bear no relation to underlying value defined as the potential to generate future cash flows. Indications of price for instruments that

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Notes

These features are themselves not always mutually reinforcing, and the respective priorities assigned to them in accounting standards depend on the political economy in which standard-setting takes place. For a more in-depth analysis, see Véron et al. (2006).

Goldman Sachs, for example, had $96.4 billion of assets marked to model (‘level 3 assets’ in US GAAP jargon) on its balance sheet as of end-February 2008 (Onaran, 2008).

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

The chairmen of EFRAG and of its Technical Expert Group publicly distanced themselves from the three experts' proposal (Tidström and Enevoldsen, 2008).

A proposal to create a European chief accountant is developed in Nicolas Véron (2007).

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