In the Balance

Why are some European institutions working to undermine progress toward global accounting standards?

BY CHRIS DREYER, CFA

The G20 leaders, in their recent Washington, DC, summit, have made financial transparency and disclosure top priorities. Some European institutions (chief among these being the European Commission under French leadership) have a different agenda. Their recent pressure on the International Accounting Standards Board (IASB) has already yielded some retroactive changes of accounting standards—without due process—that will enable preparers to retroactively reclassify positions that are under water without exhibiting losses in their income statement.

The most notable casualty of this action is IASB's independence. Recent action by the U.S. Securities and Exchange Commission—issuing its roadmap proposal for U.S. adoption of International Financial Reporting Statements (which would replace U.S. GAAP by 2014)—brought global markets one important step closer to the objective of a single set of global, high-quality accounting standards. But the political challenge by European institutions has placed the IASB's independence and progress toward global harmonization in jeopardy. Ironically, it was the European Union's decision to make International Financial Reporting Statements mandatory for all EU-listed companies beginning in 2005 that put IFRS on the road to global success. What went wrong?

Tensions between the European Union and IASB are rooted in institutional differences and technical arguments. At an institutional level, politicians in Europe still struggle with their past decision to surrender sovereignty in setting accounting standards to an independent international body of experts, even though that surrender was not unconditional. In fact, the EU has retained its own *nuclear option* in that it has reserved the right to not endorse entire standards or parts thereof in its jurisdiction. By deploying that nuclear option, however, it creates a regional variety of *IFRS as endorsed by the EU*, which is obviously in conflict with the IASB's objective of a single set of global standards. Being the single most important adopter of IFRS to date, the EU reckons that it can leverage its sheer size in the standard-setting process to the extent that it has an effective veto against specific proposals. But as IFRS deployment proliferates around the world, this nuclear option loses its deterrent value.

In regard to technical considerations, some influential European preparers are unhappy with the increasingly important role that fair value accounting plays in the IFRS context. This dissatisfaction may be attributable to an important structural characteristic of many continental European markets in which a dominant group of lead shareholders (family, management, etc.) often holds sway. These shareholders usually do not depend on the transparency offered by the IASB's approach, which favors a fragmented ownership structure.

The explosive potential of this combination of instutitional and shareholder interests is hardly news. It blew up once before during the controversy over IAS No. 39 (valuation of financial instruments), which was debated amid threats of a European carve-out and interventions from the French presidency. Now, with the credit crisis in full swing and markets going downhill, the detonators have been armed once again.

At stake now is the stability—if not the very existence—of the financial system. Some contend that the downward spiral of selling pressure has been caused and accelerated by the implementation of fair value rules of valuation. According to this line of argument, accounting standards force banks to sell positions in weak markets to protect their equity. Hence, fair value needs to be suspended, if not abandoned altogether, in order to break the vicious cycle.

There is just one glitch in this argument: it is wrong. The selling pressure is not caused by fair value but by rigid handling of prudential capital requirements in an environment of highly leveraged balance sheets with a frail equity base. Thus, stabilization measures need to address prudential regulation practice rather than valuation methods in accounting standards. Fortunately, that understanding prevailed at the G20 crisis summit in Washington.

Business reports *are* important sources for prudential regulators, but they are far from the only ones. Regulators are in a position to ask super-

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vised entities for more information whenever they need it. Investors do not have that power, which is why our need for transparent information has to overrule other concerns. And as the the CFA Institute Centre for Financial Market Integrity has documented in its *Comprehensive Business Reporting Model*, fair value is the most relevant information for financial decision making.

Opponents of fair value continue to pose a threat, as demonstrated by the IASB's recent concessions. Proponents of fair value and IFRS can take heart from the G20 decision to support the objective of a single global set of high-quality accounting standards and the U.S. SEC's proposal for convergence. These hopeful signs diminish but do not eliminate the threat posed by the European Union, instrumentalized by powerful interest groups. On a number of issues, the EU still requests relaxation of accounting standards before year-end. Thus, future skirmishes—to be fought in the name of stability—are inevitable.

Still, despite all the setbacks, global markets have taken a major step toward a single set of accounting standards. From the investor's perspective, achievement of this goal is desirable if the standard setter is capable of protecting its integrity from well-organized pressure groups. If undue political influence cannot be neutralized otherwise, the second best alternative would be competition between two families of accounting standards. The best solution, however, is a configuration among sovereign entities capable of counterbalancing each other, such as the European Union, the United States, Japan, and China.

The final outcome still hangs in the balance.

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Does Mark-to-Market Accounting Compromise Important Objectives?

BY THOMAS WILKINS, CFA

The "official position" of CFA Institute is that "fair value information (based upon market values for identical or similar assets or liabilities) is the *only* information useful for investment decision making." Should this word "only" be reevaluated? Do the costs of this approach outweigh their benefits? Would broader latitude of analysis increase the scope to investors as a result of the following questions?

1. If there is no trading in an identical or similar asset or liability, this means that the investment is worthless. Should this view be sorted and ranked with other objectives to see if this "only" excludes other important CFA Institute objectives?
2. Some investors may purposefully seek illiquid investments because of perceived values. Such investors may not equate insolvency with illiquidity. Would this "only" clause steer investors away from their own investment objectives, and hence, would this action decreases liquidity and risk taking?
3. Does mark-to-market accounting increase the importance of quarterly reports and lessen their importance for long-term studies?
4. Does mark-to-market accounting improve or hinder transparency and increase or decrease risk?
5. Is the question at hand to have "one or the other" (that is, mark to market or present value of cash flows)? If contrarian views increase transparency, would the increase come with pros and cons?
6. According to one survey, 69 percent of investors with $500,000 or more select their investment advisers based on trust. Does a one-sided view hinder trust when an investor is not given alternative views?
7. Does mark-to-market accounting increase the appeal of frequent trading and volatility because the mark-to-market prices are changing rapidly? Does this convince many investors to give up long-term goals and switch to more rapid turnover?
8. Does mark-to-market accounting limit the boundary of charterholders' competency and limit the objectives of the CFA Institute Code and Standards?
9. Does exclusive reliance on mark-to-market accounting at the exclusion of alternative views have a role in runs on banks, mutual funds, and brokerage accounts?

While mark-to-market accounting is an important tool, it is not the only one in need of examination. "One or the other" methodology has its disadvantages. I do feel that more information with an alternative view is better for liquidity, valid risk taking, and long-term investing (rather than short-term trading) and does not come at the exclusion of the benefits of long-term investing, transparency, less reliance on quarterly reporting, and (finally) a protection against surprise mergers that put in a completely differently context what investors knew sometimes only hours ago during market hours.

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(The CFA Institute position is posted on the CFA Centre portion of cfainstitute.org. Under "Research Topics and Positions," select "financial reporting" and then "fair value reporting.")