

All Roads Lead to Fair Value Accounting

Fair value accounting – The mere mention of this phrase is enough to create buzz and chatter within the accounting and finance circles, especially in an unprecedented era of global credit crisis ever since the savings and loan crisis in the 1990s. The collapse of Bear Stearns and IndyMac, coupled with waves of massive write downs in the balance sheets of Wall Street banks are definitely the corporate theme of 2008 and along with it, fair value accounting.

Love it or hate it, following its international implementation by the Basel II accord and the affirmation in the International Financial Reporting Standards ('IFRSs') by the International Accounting Standards Board ('IASB'), fair value accounting is certainly the mainstream of accounting and auditing standard setters worldwide. International financial reporting has evolved a long way since its classical introduction by Luca Pacioli, from historical cost accounting to other fashionable forms of accounting such as current cost accounting and current purchasing power accounting, and back to historical cost accounting before turning to the present fair value accounting.

Financial reporting based on historical cost – is old indeed gold?

Historical cost accounting remained contemporary throughout the decades and served its purpose well until globalisation became a tectonic trend that ushered the finance world into a new era of proliferation of financial products with incredible complexity. Creative attempts to financially re-engineer reported balance sheets and profits saw financial derivatives taking center stage to the extent of being referred to as 'weapons of mass financial destruction', culminating with the collapse of Enron and Worldcom in early 2000. Corporations discovered ways of circumventing historical cost accounting by entering into financial derivatives to boost profits or balloon balance sheets due to the rear view taken by the financial reporting systems back then.

The chain of corporate collapse in early 2000 set in motion the wheels of change, pushing regulators worldwide to consider a new form of accounting and from the ashes, emerged fair value accounting as the way forward. Notwithstanding the intricacies of the IFRSs, fair value accounting requires the reflection of financial assets and financial liabilities at willing buyer-willing seller prices. All financial products (or instruments) can no longer escape from the scrutiny of investors; gains or losses are now recognised even before the financial instruments mature and truly, investors will know the economic performance and condition of corporations.

Corporations groaned from the increasing weight of financial reporting burdens, investors renewed their faith in corporate reporting and regulators breathed a heavy sigh of relief. Well, so the story goes until recently with the global credit crisis starting with the irrational exuberance in the United States economy. Poor lending standards adopted by financial institutions that fuelled the earlier years of growth in the housing market reared its ugly head when the housing bubble burst under the growing weight of rising oil prices, yielding high default rates. Fixed income instruments and derivatives tied to those housing loans in asset securitisation exercises consequently suffered default losses and were forced to register those losses upfront in accordance with fair value accounting. Trust and faith in the credit standings between financial institutions collapsed to an all-time low and thereon, liquidity dried up as institutional lending screeched to a grinding halt, exacerbating the crisis of confidence despite attempts by the Federal Reserve to reassure the market.

Interestingly, the write downs recognised in the balance sheets of corporations sparked a chain reaction throughout the financial markets since a corporation's liability is another corporation's asset as some form of investment. Hence, a corporation's failed liability becomes another corporation's failed asset in a downward financial spiral since exchange traded prices of securities held are the first reference employed (sometimes referred to as mark-to-market) in fair value accounting. True to the psychology of investing, finger-pointing became a favourite pastime with credit rating agencies such as Standard & Poor's and Moody's bearing the brunt of criticisms, and of course, fair value accounting.

Would the ongoing global credit crisis nail fair value accounting to the coffin?

The Chartered Financial Analysts ('CFA') Institute Centre for Financial Market Integrity conducted a survey amongst CFA members in March 2008 with startling results; whilst 55% of the respondents opined that fair value requirements aggravate the global credit crisis, 79% are of the opinion that fair value requirements improve transparency and contribute to investor understanding of the risk profiles of financial institutions. Meanwhile, G-7 Finance Ministers and Central Banks urged the IASB to improve the accounting and disclosure standards for off-balance sheet entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments in periods of stress. The Basel Committee on Banking Supervision promised to work with accounting and auditing standard setters to promote enhanced guidance on fair value estimates for financial reporting purposes and their verification by auditors.

Indeed, all roads lead to fair value accounting! The CFA Institute Centre for Financial Market Integrity even reaffirmed its support for fair value accounting as the most transparent measurement for investors to analyse financial statements, saying that fair value is being used as a scapegoat by corporations who have made poor decisions or were not in compliance with accounting standards.

Fair value accounting in Malaysia

The recent spotlight on the financial reporting requirements of IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement*, and IFRS 7 *Financial Instruments: Disclosures*, have certainly not been lost on the local front. Accounting and finance professionals in Malaysia woke up on 1 August 2008 to the tune of a press release by the Malaysian Accounting Standards Board ('MASB') detailing plans to fully adopt IFRSs and converge with the IASB's Standards. With FRS 139 *Financial Instruments: Recognition and Measurement* coming online effective 1 January 2010, we certainly need to lay to rest whatever remaining hopes of ignoring fair value accounting and move forward to acquaint ourselves and master this new financial reporting model. Whilst marking-to-market may prove relatively simple, we should also be prepared to explore and understand financial models used to value instruments that are not exchange traded (swaps and forwards, for instance) known as mark-to-model provisions.

In spite of the impending financial reporting turbulence, local accounting professionals remain surprisingly mired in a swirl of myths and misconceptions. Chief of all myths is that FRS 139 only applies to financial institutions – well, that would only be true if you do not have cold hard cash, receivables, borrowings, or even simple securities investments within the financial statements of the corporation! Another misconception stems from the languid attitude amongst preparers of financial statements – after all, FRS 139 is only effective when we report for the financial period 1 January 2010 to 31 December 2010, right? Ladies and gentlemen, considering that the first quarterly financial reports in 2010 would require submission in April 2010, we would only have 2009 to prepare for the coming wave before a direct changeover on 1 January 2010.

Not forgetting IFRS 7, public corporations in Malaysia would also need to prepare for detailed risk analysis disclosures, consistent with Pillar 3 of the Basel II accord. Risk measurements such as value-at-risk and credit-at-risk, complemented by sensitivity analysis involving factor push, worst case scenarios, and many more would eventually be part and parcel of the disclosure notes to the financial statements in an attempt to both, improve market transparency and quality of financial reporting.

You will never walk down the road alone!

Are Malaysian corporations ready for the coming task at hand? Whilst the profession possess the necessary human capital to implement fair value accounting, undeniably, financial reporting costs would increase in exchange for improved investor knowledge. Empirical research on the implementation effects of fair value accounting espoused by IFRSs in the United Kingdom shows that the increased reported income volatility did not adversely affect debt covenants, and that corporations providing voluntary IFRS disclosures back then displayed higher equity prices compared to corporations that did not. Indeed, we must continue to keep our faith in the premise that the financial markets reward corporations with transparent financial reporting as empirically observed, and embrace fair value accounting as the road to improved financial reporting.

At BDO Binder, we look forward to lending you a helping hand to surmount the coming financial reporting challenges with our array of experienced and updated professionals at your service.

This article is reproduced with kind permission from BDO Binder Corporate Office