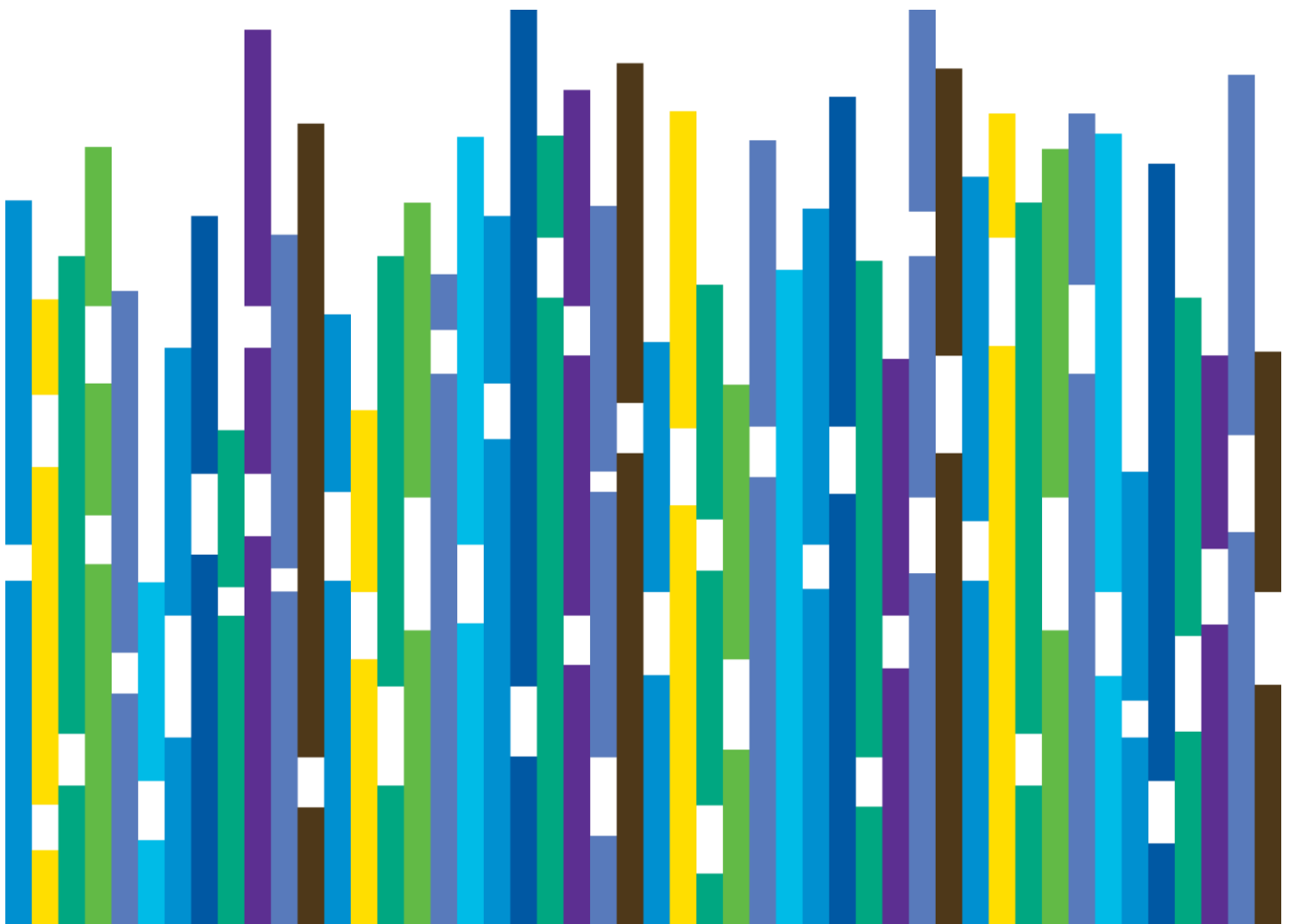


# FAIR VALUE ACCOUNTING & LONG-TERM INVESTING IN EUROPE

Investor Perspective and Policy Implications



# FAIR VALUE ACCOUNTING & LONG-TERM INVESTING IN EUROPE

## Summary of Position

Investors support the drive by European policymakers to stimulate investment and financial innovation as a backbone of Europe's economic regeneration. To that effect, the effectiveness of the accounting framework is an important element of encouraging investors who are suppliers of financial capital to be confident enough to invest in the economy, financial services sector and innovative financial instruments. For investors to be confident they need to be well informed about the financial health, prospects, and risk profile of investee firms. This overall financial profile is primarily communicated through the reported annual and interim accounts, and this heightens the importance for investors and other stakeholders of effective accounting policies.

We similarly acknowledge that there has been considerable debate in Europe and elsewhere regarding whether fair value accounting was a contributing factor to the financial crisis and whether it has resulted in adverse economic consequences. That said, we emphasize that there is support for fair value measurement by investors because the benefits of fair value information for the investment community outweigh several commonly cited concerns. CFA Institute<sup>1</sup> member surveys have consistently shown widespread support for fair value measurement by all types of investors. Also, we are not aware of any fundamental differences between long-term versus short-term investors in their view regarding the relevance of fair value information.

Our overarching message is that whilst addressing accounting issues, the emphasis of policymakers should be on enhancing the overall transparency of financial reporting information. The enhancement of financial reporting information should be primarily influenced by capital market investor perspectives rather than by that of financial intermediaries (i.e., banking and insurance industry players). As discussed below, the priorities of capital market participants would likely differ from the often emphasized need by financial intermediaries for 'business-model-based' accounting of financial instruments.

## Structure of Articulated Positions

In the below Q-and-A format, we further explain CFA Institute positions on fair value accounting and investor financial reporting priorities. The following issues are addressed:

- Important role of financial reporting in stimulating investment in Europe;
- Investor financial reporting priorities;
- Relevance of fair value information for investors, including views reflected in several CFA Institute member surveys and highlighting the difficulties in distinguishing between long-term and short-term investing for accounting purposes;
- Concerns regarding the elevated importance of 'business-model-based' accounting; and
- Refuting criticisms of fair value accounting (i.e., short termism by investors, procyclical effects, measurement unreliability and inconsistent application).

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<sup>1</sup> CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal is to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 117,000 members in 139 countries and territories, including almost 110,000 Chartered Financial Analyst® charterholders, and 138 member societies. CFA Institute promotes fair, open, and transparent capital markets and advocates for investors' protection.

## What is the role of enhanced financial reporting in stimulating investment in Europe?

As argued in a recently issued CFA Institute report *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust and Volume* (herein referred to as CFA Institute Disclosure Report), enhancing financial reporting information is an important aspect of restoring investors' trust. Indeed, there are salutary lessons to be learnt from the financial crisis regarding the perils of inadequate financial reporting practices, which have often failed to keep pace with the financial innovation occurring within financial institutions and other complex conglomerates. The financial reporting of complex financial instruments (e.g. repurchase agreements, securitization and other off-balance sheet financial instruments) has often failed to fully convey the associated risk exposures of reporting entities.

Poor disclosures led to the failure by investors to exercise market discipline whilst investing in structured finance vehicles in the run-up to the financial crisis. This failure contributed to moral hazard by lending institutions and originators of complex financial instruments. Poor disclosures also ultimately led to the erosion of trust. As evident by the extent to which the securitization market shrunk during the crisis, investor appetite for exposures in innovative financing instruments has been significantly tarnished.

The role of improved bank reporting in restoring investor trust was also highlighted by the Financial Stability Board Enhanced Disclosure Task Force (EDTF) that focused on the risk reporting of banks. The EDTF proposed that enhanced risk disclosures would reduce the mistrust by investors in bank financial statements, evidenced by low price-to-book ratios.

## What are investor financial reporting priorities?

*In a nutshell, the focus should be on transparency from the point of view of investors in loss absorbing capital and not on the preferred accounting requirements of financial intermediaries (i.e. banks and insurance companies), regardless of whether the latter engage in institutional investment activities. Investor priorities differ from the push for business-model-based accounting from the financial intermediaries.*

The consideration of investor financial reporting transparency requirements should focus on the priorities of capital market participants (i.e., equity investors). Equity investor focus is important because it is they who are exposed to the greatest amount of risk and have information disadvantages compared to preparers and several other stakeholders (e.g. regulators, auditors, bankers, and rating agencies). Only such a focus would result in the determination of the most transparent information that can contribute to trust and willingness to invest by all types of investors and capital providers.

### Need to focus on improving overall transparency of investee companies

There is clearly a need to significantly improve financial reporting as well as the reporting of other non-financial information relevant for investment decision making. The cornerstone of any reform initiatives ought to be on enhancing the communication made through annual and interim reports. Enhanced communication should aim to eliminate the information asymmetry that exists between preparers and investors regarding the investee company financial health, performance prospects, risk exposures, as well as on the sources of both short-term and long-term value creation. As discussed in the earlier cited CFA Institute Disclosure Report, existing shortcomings within the financial reporting framework necessitate reform initiatives targeted at providing complete, concise and readily accessible information to investors.

To meet investor needs, European policymakers should be supportive of the raft of initiatives undertaken by standard setters and other related initiatives (e.g. EDTF) that focus on improving the overall transparency of investee companies. For example, the push to integrate different strands of corporate reporting including financial and non-financial information, as is being considered by various initiatives including the International Integrated Reporting Council (IIRC), has plenty of potential advantages for investors. Any emphasis on enhancing strategic and other information necessary to judge long term enterprise value is welcome.

### 'Business-model-based' accounting for financial instruments is not an enabler of long-term investing and should not be considered a priority for accounting reform

As a general principle, it can be problematic when long-term investor information requirements are inferred from the preferred accounting policies of banks and insurance companies. We do not overlook that, in a European context and as part of their financial intermediation functions, banks and insurance companies tend to have asset management business segments and, in this regard, act as institutional investors (i.e. they wear dual hats being both preparers and asset managers). That said, there is a risk that policymakers may conflate preparer and investor perspectives if they rely on feedback from financial intermediaries (i.e., banks and insurance companies) to determine financial reporting needs for long term investing. Specifically, whenever financial intermediaries emphasize 'business-model-based' accounting as the appropriate basis of determining whether to apply fair value measurement for financial instruments and consider such an accounting approach to be an enabler of long-term investing. As we discuss below, this emphasis on 'business-model-based' accounting constrains the quality and comparability of information that the wide body of investors would require.

### **What are CFA Institute member views on the relevance of fair value measurement?**

We believe that fair value information is relevant for both short-term and long-term oriented investors. Over the years, we have polled our diverse membership body of investment professionals on the relevance of fair value information. The survey results have shown no discernible<sup>2</sup> difference in preferences for fair value information by investors depending on the asset class or investment philosophy.

The survey results (**presented in the Appendix**) show the relevance of fair value for all financial instruments regardless of the holding horizon for these instruments. Headline findings from the different surveys are as follows:

- 79% of respondents to a 2008 survey said fair value requirements for financial institutions improved transparency and investor understanding of the risk profile of these institutions (i.e. **Figure 1 in the Appendix**).
- 74% of respondents to a 2008 survey said fair value improved market integrity (i.e. **Figure 2 in the Appendix**).
- 60% of respondents to a 2009 survey on the International Financial Reporting Standards (IFRS) update of its financial instrument accounting requirements (i.e. IFRS 9, *Financial Instruments Classification and Measurement*), supported fair value for all financial instruments (i.e. **Figure 3 in the Appendix**).
- There was support for the application of fair value across different financial instruments, including loans, for which many have claimed it is hard to apply fair value measurement. In the 2009 IFRS 9 survey, 52% of respondents supported fair value for loans (i.e. **Figure 4 in the Appendix**). The level of support increased in the 2010 survey, with 71% supporting fair value for loans (i.e. **Figure 5 in the Appendix**).

The picture that emerges from our various surveys is that investors require both fair value and amortized cost information for all financial instruments, with fair value as their preferred main measurement approach. Thus, providing only one and not the other measurement (i.e. fair value or amortized cost) would significantly limit the overall usefulness of the reported information.

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<sup>2</sup> Our membership comprises of investors across different asset classes (e.g. equities, bonds, private equity and hedge funds) and with different investment philosophies (e.g. long term oriented value investing, passive investment funds versus arbitrage players).

## Why is fair value information relevant for all investors?

*Simply put all investors buy, sell, and hold their investments based on fair value information. Fair value information is necessary to judge current financial health, is an input to predicting future performance, and helps in the judgment of how effectively management is fulfilling its stewardship function.*

Financial statements information, including information reported on the balance sheet, income statement, other comprehensive income (OCI), cash flow statement, and notes to the accounts, are a key input to company valuation including the pricing of issued equity and debt securities. Incorporation of fair value information into the financial statements enhances the overall quality of accounting information that can be applied in fundamental valuation of companies.

### Relevant for balance sheet and income statement quality

A high quality balance sheet that includes fair value information facilitates key judgments by investors regarding asset quality, solvency, leverage, and overall risk exposures. The financial crisis has heightened the importance of fair value on the balance sheet for financial institutions (e.g., banks and insurance companies). For example, it is widely acknowledged that bank balance sheets were overstated during the financial crisis as a result of the current reporting requirements based on amortized cost measurement of loan assets, which resulted in delayed impairments. A balance sheet based on fair value measurement of loan assets would more likely reflect the economic reality in a more timely fashion than the current requirements. Even if amortized cost carrying values are reported on the balance sheet, knowledge of fair value would inform investors on the sensitivity of the reported values.

Similarly, a high quality income statement, which would include fair value gains or losses, would facilitate key judgments by investors regarding the performance and wealth creation of reporting entities during the reporting period.

### Absence of fair value information can lead to short-termism by preparers

Conversely, failure to report the fair value of assets and liabilities increases the information asymmetry between preparers and investors, and encourages short-term oriented choices by preparers. The absence of fair value information previously led to pervasive practice of 'gains-trading'<sup>3</sup> by banks due to the discretion that they had towards reporting profits and concealing losses of their portfolios. 'Gains-trading' would often result in suboptimal balance sheet management aimed at maximizing short-term management compensation.

### Empirical evidence shows the relevance of fair value for valuation and risk analysis

There is a considerable body of empirical evidence gathered over the last few decades showing that fair value information on the balance sheet, income statement, OCI, and notes to the accounts is relevant for stock and bond pricing (i.e., value relevant). A good summary of these studies is provided by Barth and Landsman (2010). Most recently, Blankespoor, Linsmeier, Petroni, and Shakespeare (2013) showed that if leverage of U.S. banks had been determined based on fair value information, such leverage measures would have resulted in greater predictive power regarding the following: credit risk, and the likelihood of bank failures under distressed economic environments. In other words, investors would be better served by incorporating fair value information into their company analysis.

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<sup>3</sup> Gains trading is the practice of purchasing securities and then selling those that subsequently appreciate in value while retaining as investment portfolio assets those that cannot be sold at a profit.

## Should the relevance of fair value measurement depend on the ‘business model’?

No.

As noted earlier, banks and insurance companies have expressed the desirability of ‘business-model-based’ accounting to determine whether or not fair value measurement should be applied to their financial instruments holding. This desire by financial intermediaries has in large part informed the financial instruments accounting updates under IFRS 9. The emphasis on ‘business-model-based’ accounting is consistent with the longstanding tendency of preparers to prefer accounting policies that accord flexibility and options in how they depict performance through the net income statement.

However, from an investor standpoint, there would be concerns with ‘business-model-based’ accounting for the following reasons:

- Lack of comparability– Financial reporting comparability is reduced when similar financial instruments (e.g., sovereign bonds) have different accounting treatment due to differences in the intended holding period by preparers (i.e., as a result of expressed differences in business model).
- Relevance of fair value information does not change with holding period of financial instruments – The intended or actual holding period should not dictate whether to report on the fair value of financial instruments. To begin, management’s intended holding period can change to: a) avoid recognizing economic losses; or b) give management flexibility in how they portray performance. As was evident during the sovereign Euro-debt crisis, several European banks reclassified their sovereign bond holdings (e.g., Greek government bonds) to avoid recognizing losses as would be required through fair value measurement. The reclassification was predicated on an expressed intention of only holding these bonds to collect contractual cash flows. For some of the banks, the articulated intended holding period of sovereign bonds changed from period to period. Other banks sold the securities much sooner than that which management had expressed to be the intended holding horizons.

Second, regardless of the holding period, fair value reporting of investment securities including the mentioned sovereign bond holdings would have informed investors on the asset quality of the bank balance sheets. As we emphasize in this paper, even if investors have long holding horizons, they still need to assess the value and risk of their investment holdings on an ongoing basis.

Third, it is important to emphasize that when valuing companies, investors analyze the likelihood and risk of realizing future cash flow across the portfolio of a reporting entity’s recognized and unrecognized assets (i.e. including intangible assets) and liabilities. Though the holding horizon of individual assets and liabilities within the reporting entity can inform on entity-wide cash flow characteristics (i.e., amount, timing and uncertainty of enterprise wide future cash flows), investors primarily consider the value creation from the combination of assets and liabilities when predicting future cash flows for valuation purposes. Therefore, policymakers should not emphasize the holding periods of individual assets and liabilities of financial intermediaries, as a long-term investing consideration. Such an emphasis is inconsistent with the valuation perspective of external shareholders.

- Lack of ‘business model’ definition – The business model concept is largely undefined under accounting standards and it is likely to be applied in a restrictive and subjective sense.
- Flexibility in communication about business model through management commentary – Preparers have latitude to communicate how they undertake value creation activities (i.e., describe business model in an expansive sense) through the management commentary disclosures.

The 2010 CFA Institute comment letter response to the Financial Accounting Standards Board (FASB) proposed financial instruments accounting standard update – further articulated investors’ reservations regarding the application of the ‘business model’ concept in financial instruments accounting.

## Does fair value measurement contribute to short-termism by investors?

CFA Institute disagrees with the notion that fair value information contributes to short-term oriented asset allocation/security selection by capital market participants. We do so for the below reasons.

### Lack of evidence that fair value leads to investor short-termism

To begin, it is hard to point out to any compelling empirical evidence showing that fair value information does influence the behavior of investors in a manner that shortens their investment horizons. We are not aware of any 'cause and effect' evidence showing a link between fair value reporting by investee companies and changes in investor holding horizons. Specifically:

- We are not aware of any evidence showing that investor holding horizons were shortened after the introduction of IFRS in Europe in 2005. IFRS adoption required and introduced the recognition of derivatives on a fair value basis across many European jurisdictions.
- We are not aware of any evidence showing that investors in jurisdictions, business models and investee companies that have limited application of fair value recognition and measurement tend to have longer holding horizons than those where fair value recognition and measurement is more widespread.
- We are not aware of any evidence showing that investors with short-term holding horizons rely more on fair value information during fundamental valuation of companies than would be the case with those characterize themselves as long-term investors.

The 2013 European Commission Green Paper on Long-term Investing (Green Paper) asserted the following:

*'Some research highlights a reduction by institutional investors in equity allocations in investment portfolios, since equity is considered more volatile and risky than bonds. Other research argues that market-consistent valuation may encourage long-term investors to increase their risk exposure, if the volatility is recognized outside their profit and loss accounts.'*

While not disagreeing with the Green Paper's observation that there has been a rotation from equities to bonds by some institutional investors, it would be a tenuous linkage if such movement across asset classes were attributed to the accounting policies of investee companies (e.g., whether they apply fair value accounting). Asset class rotation occurs during different phases of economic cycles and the movement across equity and bond asset classes is not unidirectional (i.e., occurs both ways depending on economic environment). Investor preference for either equity or bonds is driven by several factors including the interest rate levels, risk aversion of investors, inflation levels, etc. In addition, the claim that long-term investors are seeking riskier choices due to reported accounting volatility does not amount to any evidence of suboptimal asset allocation, as the pursuit of riskier choices would likely be premised on maximizing risk-adjusted return. In other words, investors explicitly consider and price risk when valuing companies and consider additional required return per unit of additional risk.

### Similar information needs for short-term and long-term investors that perform fundamental valuation

Many investors (e.g. merger arbitrage hedge fund investors), who have relatively short holding horizons, often perform fundamental valuation based on in-depth evaluation of financial statements as described by Kroijer (2012). They do so in a manner that would be consistent with the valuation approach undertaken by investors with longer holding horizons. Besides, long-term investors also have to continuously monitor the value of their investment assets, even when they choose to hold such assets for long periods. The similarity in information for fundamental valuation, regardless of the investment horizon, highlights the difficulty in distinguishing long-term versus short-term investing for accounting purposes.

It is also worth remembering that investors who are sometimes characterized as myopic and short-term oriented are often acting in the interest of long-term investors by: a) facilitating price discovery; and b) ensuring investee firms deliver long-term shareholder value. For example, a recent academic paper (Bebchuk, Brav and Jiang, 2013) provides comprehensive evidence refuting commonly cited claims that interventions by activist shareholders, and in particular activist hedge funds, have an adverse effect on the long-term interests of companies and their shareholders. The paper found that operating performance improved in the five-year period following activist interventions.

## Does fair value-related associated volatility in financial statements contribute to undesirable stock price volatility?

Before addressing whether fair value information is inappropriately priced by investors and thereafter leads to 'noisy' stock price fluctuation, a more fundamental question is whether any such observed stock price volatility is being driven by changes in fundamental economic factors (i.e., macroeconomic, industry, and/or company specific factors). Fair value gains or losses reflect changes in the values of assets and liabilities driven by changes in fundamental economic factors (e.g., interest rate changes). Hence, the question remains whether investors can ignore fair value information in their investment decisions?

Suffice it to say, it would be detrimental for either short- or long-term investors to fully ignore, under all circumstances, such fundamental factors that are resulting in stock price volatility. Even if long-term investors anticipate that changes in fundamental factors would reverse during their holding periods, it is necessary for them to form a view on whether and the extent to which their investment holdings could be mispriced at any point in time. Said differently, both long-term and short-term investors should not ignore fair value information that informs on the company value at a particular point in time.

In general, concerns about net income volatility tend to arise when there is a fixation by different market participants towards net income as being the only relevant valuation input. A corollary of this fixation is the view that net income has to be stable with little fluctuation from year to year so as to be a suitable predictor of future periods' net income. Another corollary of this fixation is the view that fair value measurement, which contributes to net income volatility would be seen as 'noisy' in terms of informing on long-term value. However, such concerns reflect a restrictive perspective on the usefulness of different elements of accounting information for investment analytical purposes. Consequently, too much emphasis is placed on the presentational 'geography' (i.e., OCI being preferred to net income) of particular decision-useful information, such as unrealized fair value gains or losses, simply to minimize net income volatility.

Unrealized fair value gains or losses can have predictive value on future periods' net income, and realizable cash flow and are relevant for investors. Recent academic evidence (Jones and Smith, 2011) has shown that specific unrealized gains or losses reported in OCI are relevant for valuation purposes, and as such there is really no reason why such information should not be reported on the income statement.

Regardless of where accounting information is reported (i.e., income statement or OCI), ignoring the information content of such information simply because it has volatile characteristics, even when such volatility represents economic volatility, will result in investors effectively ignoring decision-useful information. To illustrate this point, **Table 1** below, with data from a sample of European banks, shows that there can be significant unrealized fair value gains or losses on available-for-sale (AFS) debt and equity financial instruments. Investors cannot afford to ignore performance information related to AFS portfolio holding simply because such information is volatile in nature. The information on unrealized gains or losses can inform investors on the stewardship effectiveness and effective balance sheet management.



**Table 1: Sample European Banks: AFS Fair Value Unrealized Gains or Losses**

Company	Year	ROE	Unrealized Gains(Losses)/Equity
HSBC	2009	4.9%	7.2%
Intesa Sao Paolo	2012	3.3%	7.2%
BBVA	2007	23.0%	6.7%
Lloyds Banking Group	2011	-5.8%	5.6%
BNP Paribas	2012	7.7%	5.0%
BBVA	2010	13.3%	-5.2%
Intesa Sao Paolo	2011	-17.0%	-5.8%
Banco Santander	2008	15.6%	-5.9%
BBVA	2008	20.2%	-7.7%
RBS	2008	-42.9%	-8.5%
Banco Sabadell	2008	15.2%	-9.6%
Banco Sabadell	2010	6.7%	-10.6%
Deutsche Bank AG	2008	-12.2%	-14.1%
Lloyds Banking Group	2008	8.2%	-21.0%
HSBC	2008	-12.2%	-23.7%

\*Source Annual Reports. The display of data is in descending order of unrealized gains/losses as a proportion of equity

### What about the procyclicality and measurement reliability concerns that some claim arises due to fair value measurement?

*Emerging evidence shows that concerns regarding the procyclicality of fair value measurement were likely overstated. In addition, the accounting standard setters have issued guidance on the application of fair value measurement which includes enhanced disclosures to allow investors to better understand the measurement uncertainty associated with fair values.*

#### Procyclicality concerns have been overstated

Georgescu and Laux (2013) reviewed the reporting of European banks, and they note the following prominent 'myths' on the relationship among financial reporting, financial regulation, and financial stability:

- *First, the recognition of banks' assets at fair value played an important role in the demise of banks.*
- *Second, the accounting rules underlying published financial statements have a direct effect on banks' regulatory capital.*
- *Third, historical cost accounting would have resulted in more conservative debt levels.*

The paper contends that these 'myths' have been dispelled by recent academic evidence on U.S. banks as well as by evidence that the paper presents regarding three German banks that failed during the crisis.

There is natural procyclicality inherent within the banking business model. During economic downturns and phases of credit contraction, banks would typically shrink their balance sheets to safeguard their solvency and capital adequacy. That said, the claim of unnatural procyclical effects of fair value accounting is often made by its critics. Unnatural procyclical effects would only arise if forced asset sales to meet regulatory capital requirements were triggered by excessive fair value asset write-downs (i.e., the belief that assets were reported below their fundamental economic value). Forced asset sales would trigger a downward-spiraling effect on asset prices and bank asset values (i.e., forced asset sales would reduce the value of bank balance sheets which would then force further asset sales). For this reason, several commentators assumed that if fair value write-downs by banks occurred during the crisis, then such write-downs had to be procyclical in nature.

However, the claims of excessive write-downs on bank balance sheets during the crisis overlooked that both IFRS and U.S. GAAP requirements<sup>4</sup> allow internal model determination of fair value (i.e., preparers can ignore external market-based prices) when there are disorderly markets (i.e., with no willing buyer and seller transacting at arm's length). **Table 2** shows that for a sample of European banks, level 1 fair value assets (i.e. based on quoted market prices of identical financial instruments and usually relating to trading assets) were 48% of the total assets reported at fair value on the balance sheet. In other words, the assertion of excessive write-downs due to fair value measurement is most likely imprecise. On the contrary, there is plenty of evidence of delayed write-downs by banks during the crisis, due to these banks not applying fair value measurement for loans. This evidence is highlighted in another academic paper (Laux and Leuz, 2010).

**Table 2: Fair Value Measurement for a Sample of European Banks from 2006 to 2010**

	% of Total Assets	% of Total Fair Value Assets
Level 1 Fair value Assets	13%	48%
Level 2 Fair value Assets	11%	43%
Level 3 Fair value Assets	2%	9%
<b>Observations</b>	<b>408</b>	<b>408</b>

Source: Bosch (2012) research paper

Furthermore, recent empirical evidence shown below highlights that the concern regarding the procyclicality due to fair value accounting is likely overstated:

- Regulators have latitude to exclude unrealized fair value gains or losses from regulatory capital. For example, the European Banking Authority (EBA) 2011 recapitalization tests<sup>5</sup> shows that prudential filters resulted in 55% of gains or losses related to sovereign exposures being excluded from regulatory capital levels.
- Schaffer (2010) shows that there was no evidence of forced sales due to write-downs by U.S. banks during the financial crisis.
- The proportion of fair value based write-downs is insignificant compared to the write-downs made on financial assets accounted for on an amortized cost basis. This is demonstrable for European banks when the composition of balance sheets is broken down in **Table 3** by assets measured at fair value (i.e., trading and available for sale assets) versus those measured at amortized cost basis (i.e., loans and held-to-maturity assets). Amortized cost assets range from 46 to 84%. Fair value through profit and loss assets range from roughly 2 to 38%.
- As shown by Georgescu and Laux (2013), several key German financial institutions that failed during the crisis or were rescued, did not apply fair value accounting on financial instruments prior to the financial crisis.

In sum, there is no evidence of the unnatural procyclical effects of fair value accounting.

<sup>4</sup> IFRS requirements specify an input based hierarchy of financial instruments for fair value determination with three levels of inputs

- Level 1: Quoted market prices of identical financial instruments.
- Level 2: Inputs based on observable market data.
- Level 3: Inputs not based on observable market data.

<sup>5</sup> <http://www.voxeu.org/article/short-guide-eba-s-recapitalisation-results>.

**Table 3: Illustrative Bank Assets by Country and by Accounting Classification at Year-End 2007**

As a % of total assets	German Banks		UK Banks		French Banks		Spanish Banks	
	Large	Small	Large	Small	Large	Small	Large	Small
Trading assets and derivatives (Fair value through profit and loss)	34.9%	7.3%	27.6%	3.8%	37.8%	5.0%	10.4%	1.8%
Available for sale (Fair value through OCI)	12.2%	16.9%	9.4%	2.7%	11.9%	10.7%	6.2%	8.5%
Held to maturity (Amortized Cost)	0.2%	3.7%	0.1%	0.7%	2.0%	3.6%	0.8%	3.1%
Loans (Amortized Cost)	45.5%	68.2%	56.4%	76.4%	40.5%	76.4%	70.5%	80.4%
<b>Total financial instruments</b>	<b>92.8%</b>	<b>96.2%</b>	<b>92.5%</b>	<b>91.8%</b>	<b>92.2%</b>	<b>95.7%</b>	<b>87.9%</b>	<b>93.8%</b>
<b>Number</b>	17	7	8	13	8	12	6	42

Source: Georgescu and Laux (2013)

#### Measurement reliability and inconsistent application of fair value addressed by accounting standards updates

A commonly cited criticism against fair value accounting relates to the measurement reliability of amounts determined during phases of market exuberance (e.g., during the pre-crisis period). Critics claim that such fair value amounts sometimes failed to reflect the fundamental economic value of assets, inflated bank balance sheets and contributed to procyclicality (i.e. banks took on too much leverage during exuberant market phases). However, there are several counter arguments to these concerns including those articulated by Laux and Leuz (2009). The counter arguments include:

- Prudential regulators have ultimate responsibility for capital adequacy – Admati and Hellwig (2013) provide well-founded arguments to the effect that procyclicality and excess risk-taking within the banking sector is largely a consequence of undercapitalized banks. Hence, there is a need to distinguish the role of prudential regulation versus the role of financial accounting standards towards managing procyclicality, ensuring adequate capital and safeguarding financial stability. It is true that prudential regulators use book equity as a starting point whilst assessing capital levels. Nevertheless, it ultimately remains the prudential regulators' role to calibrate regulatory capital and determine the appropriate accounting information adjustments, so as to ensure capital adequacy across banks through different phases of the economic cycle. As noted earlier, regulators in many jurisdictions have excluded unrealized fair value gains or losses from regulatory capital.
- Excess risk-taking is enabled under the historical cost accounting regime – As was evident from past financial crises (e.g., U.S. savings and loans crisis, Japanese and Swedish bank crises in the 1990s), poor balance sheet management, excess leverage and risk-taking by banks, can occur under the historical cost accounting regime (i.e., the main alternative to fair value accounting). The absence of fair value information encourages moral hazard by banks that originate financial instruments. Fair value measurement requires the timely recognition of gains or losses and provides an early warning system on risk exposures of financial instruments. In so doing, it facilitates the ability of investors to undertake market discipline and for banks to take corrective action if there is an impending crisis. On the contrary, amortized historical cost measurement allows discretion in the timing of recognizing losses. This often results in preparers delaying or hiding existing losses on financial instruments. It also provides the backdrop for excess risk-taking by banks. Without having a full picture of underlying risk exposures of reporting entities, as would be conveyed through fair value reporting, investors are less equipped to exercise market discipline. Furthermore, Laux and Leuz (2009) argue that procyclicality is likely under an amortized historical cost regime because amortized cost measurement enables 'gains trading' where management has discretion to buy and sell securities and control the timing of the recognition of gains or losses.

To further illustrate that historical cost measurement would not pre-empt excess risk-taking by banks, Georgescu and Laux (2013) highlight the failure of three prominent German bank failures in the financial crisis of 2007-2008 (i.e., Deutsche Industriebank AG (IKB), Landesbank Sachsen Girozentrale (Sachsen LB), and HypoReal Estate Holding AG (HRE)). These three banks were regulated based on historical cost accounting under German local GAAP (HGB). Yet, these banks took on very high leverage either on-balance sheet (HRE) or off-balance sheet (IKB and Sachsen LB), and this ultimately led to their demise. The same observation can be made in respect of Northern Rock in the UK.

- Enhanced disclosures can augment investor understanding of reported fair values – Nothing stops the management of reporting entities from disclosing what they assess to be the fundamental intrinsic value of assets. They should be able to disclose their assessment of intrinsic value further to reporting on the prescribed fair value amounts. As discussed earlier, reporting both the fair value and amortized cost is useful for investors. In addition, the disclosure of management’s assessment of intrinsic value would be relevant for investors, should such an assessment differ from either the reported fair value or amortized cost. That said, it remains puzzling why reporting entities do not voluntarily disclose any additional information considered to best reflect the fundamental economic value of held assets, if such information exists.

To address concerns regarding measurement reliability and inconsistent implementation of fair value measurement, the IASB and FASB have updated their respective standards. The IASB issued IFRS 13, *Fair Value Measurement*, which is effective from 2013. IFRS 13 provides guidance that allows the consistent application of fair value measurement across assets and liabilities. IFRS 13 and IFRS 7, *Financial Instruments Disclosures*, include required disclosures to allow investors to better understand the measurement uncertainty associated with fair values (i.e., sensitivity analysis information).

## Conclusion

As noted earlier, European policymakers should focus on enabling initiatives that aim to enhance the overall transparency of annual and interim reports. These include those aimed at enhancing financial instruments risk disclosures. In addition, a critical analysis shows that the benefits of fair value measurement for all investors outweigh the often cited concerns and that its application is required by investors.

We have emphasized that fair value information is relevant for short-term and long-term investors, who undertake fundamental valuation of investee companies. Long-term investors have to monitor the value of their investment assets on an ongoing basis, even when they choose to hold such assets for long periods. The similarity in information required for fundamental valuation, irrespective of the investment horizon, highlight the difficulty in distinguishing long-term versus short-term investing for accounting purposes. It also highlights the inappropriateness of making a ‘business-model based’ distinction for determining whether to apply fair value measurement for financial assets.

Going forward, the focus of policymakers should be on ensuring the following:

- Consistent implementation of fair value measurement requirements by reporting entities.
- Enhanced presentation of the comprehensive income statement including, a clearly defined purpose of OCI. Enhanced presentation can help investors to better distinguish between realized and unrealized gains or losses, for analytical purposes.
- Enhanced disclosure of fair value measurement related information including comprehensive disclosures about the methods used to determine fair value and the sensitivity of reported fair value amounts.

The above will contribute to the overall transparency of annual and interim reports, which in turn will increase investor trust and willingness to invest in the economy, financial services sector and innovative financial instruments.

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## Appendix Survey Results

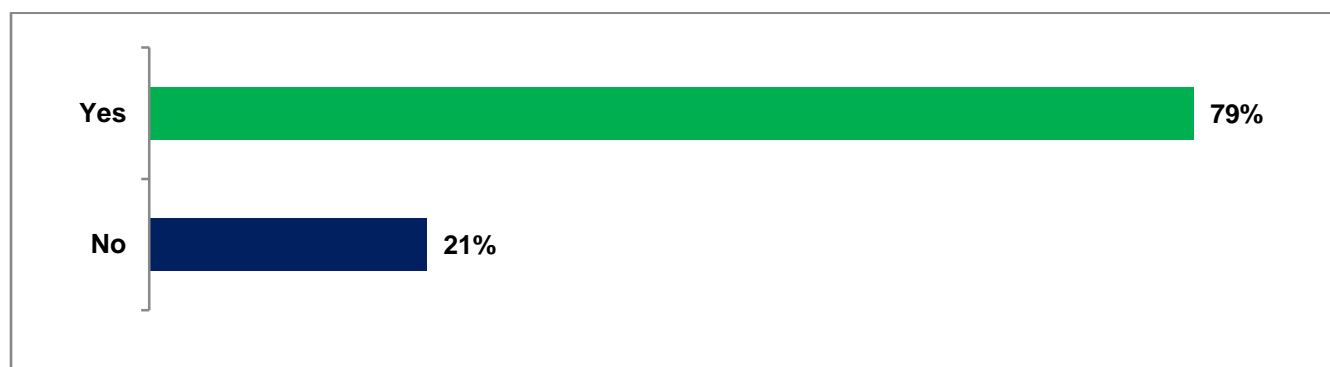
Set forth below are excerpts from our member surveys before, during and after the financial crisis. It should be noted that our surveys are completed routinely in the normal course of informing our opinions and are not completed to serve any clients or commercial interests. Our surveys do not hand-pick participants and our survey reports convey the survey methods including our unbiased sampling methodology, response rate, and demographics of participants as well as consideration of the statistical relevancy of our results.

So as to cast as broad, but as relevant, a net as possible on matters of interest such as fair value, our survey pool on most financial reporting matters is generally comprised of 15,000 to 20,000 members who are geographically representative of our membership, which is approximately 60% U.S. and 40% non-U.S. The response rate we received on the surveys below is statistically relevant and consistent with other surveys in both number of participants and response rate.

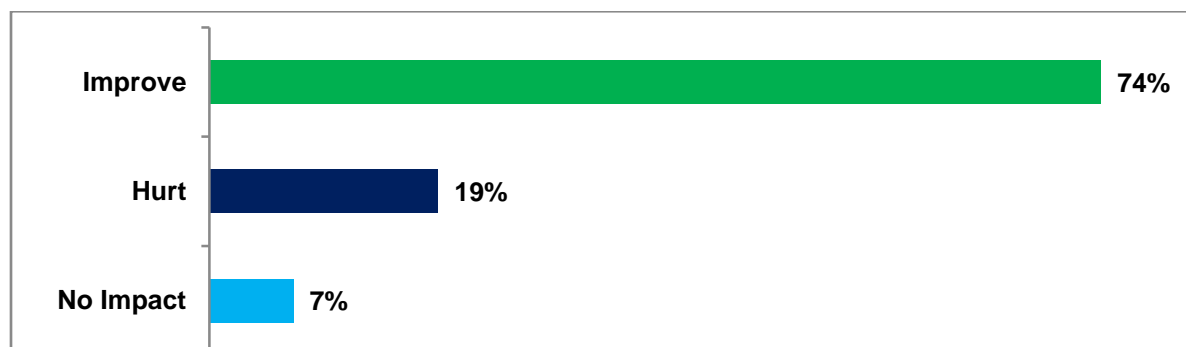
### March 2008 Survey (Figures 1 and 2)

As the financial crisis emerged in March 2008 we submitted a Question of the Month to our entire membership. 2,006 of our members responded and two key messages were received from our members.

**Figure 1:** *Do fair value requirements for financial institutions improve transparency and contribute to investors understanding of the risk profiles of these institutions? N=2,006*



**Figure 2:** *What is the overall impact of fair value requirements on market integrity? N=2,006*



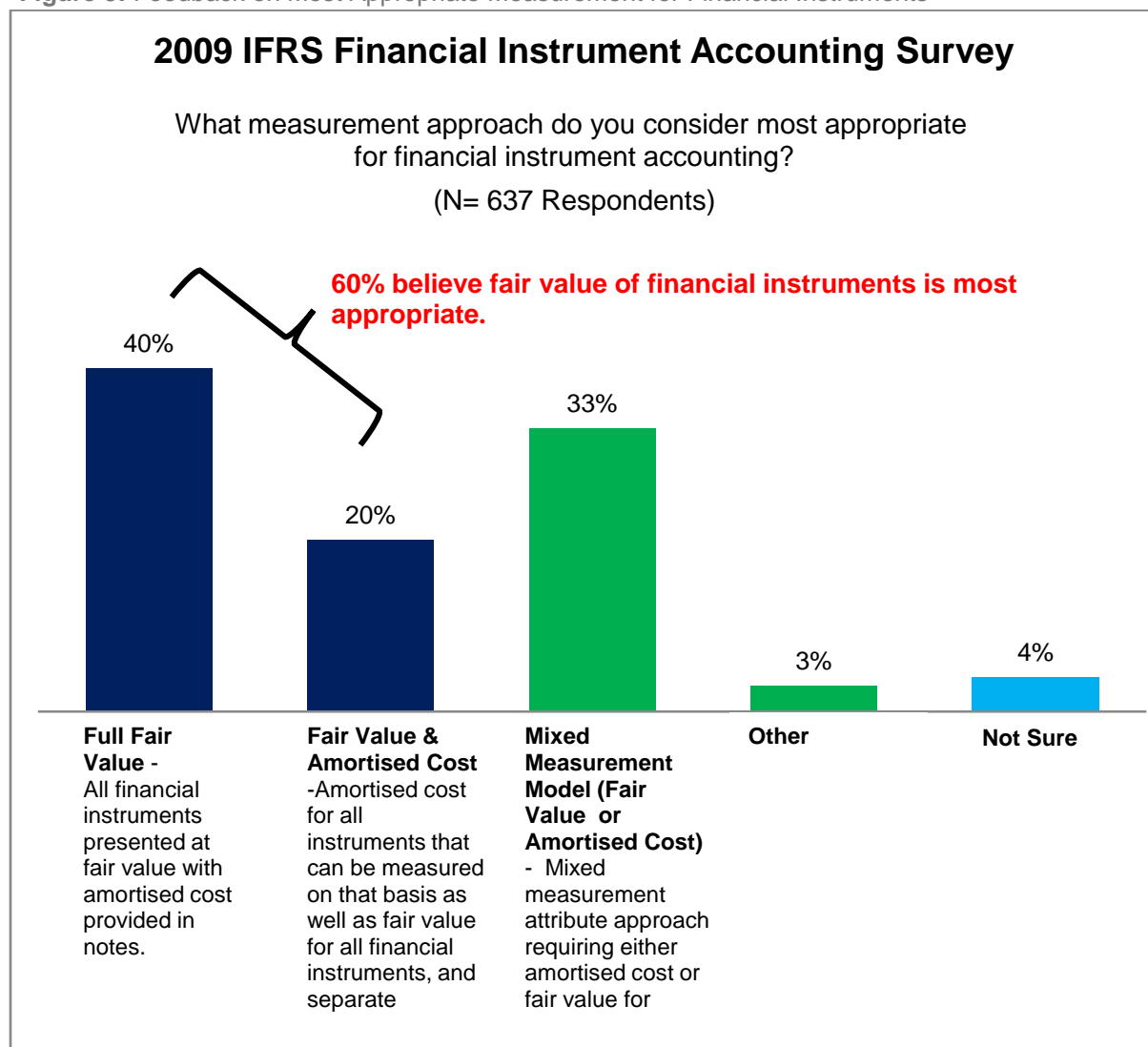
### November 2009 Survey (Figures 3 and 4)

We conducted a survey in November 2009, just subsequent to the issuance of IFRS 9. This survey was sent to approximately 16,300 members. In addition to our normal survey group, we also sent the survey to participants in our IFRS 9 webcast and to a group of members with expressed interest in financial reporting topics.

### Feedback on Most Appropriate Measurement for Financial Instruments

60% of our 637 member respondents supported either full fair value for all financial instruments or fair value with amortized cost presentation side-by-side for all financial instruments. 33% of respondents supported a mixed measurement approach with the remaining 7% not sure or desiring another measurement basis. Post-crisis, therefore, we found slightly higher support for fair value.

Figure 3: Feedback on Most Appropriate Measurement for Financial Instruments

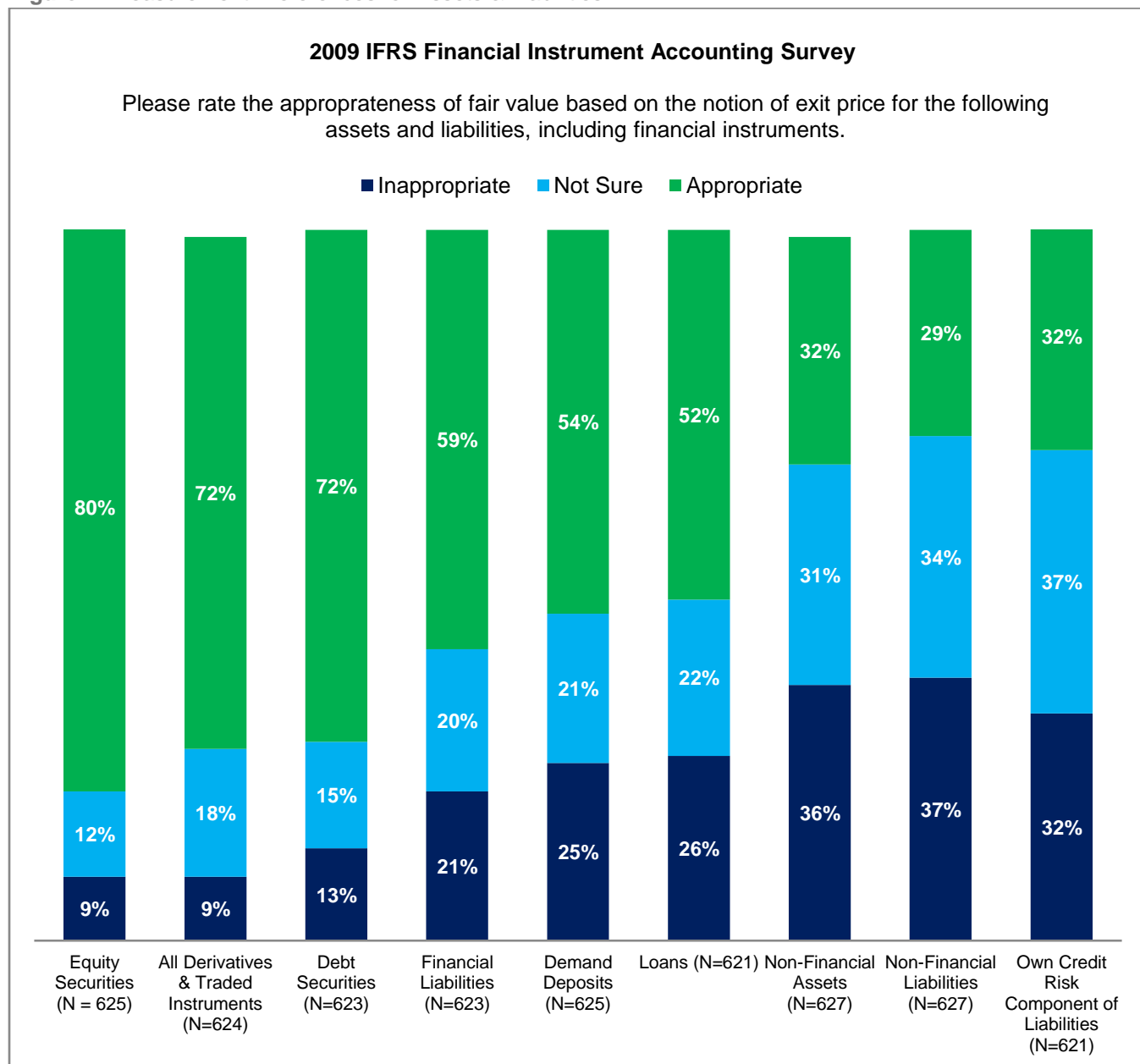




## Measurement Preferences for Assets & Liabilities

In the 2009 survey we also asked our participants to rate their preference for fair value by class of asset or liability. The survey results showed a significant majority (72 – 80%) of participants supported fair value for equity securities, derivatives, and debt securities. A majority of participants (52-59%) supported fair value for loans, demand deposits and financial liabilities.

**Figure 4:** Measurement Preferences for Assets & Liabilities



### September 2010 Survey (Figure 5)

Using a sampling technique consistent with previous surveys, we asked our members to express their views in late September 2010 obtaining 1,100 responses. **Figure 5** shows the support for fair value of loans was 71%— an increase from 52% from the 2009 survey reported in Figure 4. These results – subsequent to the significant public debate on the fair valuing of loans – reaffirm that CFA Institute members continue in their strong support for fair value as the preferred measurement basis for loans.

**Figure 5:** *What is the most transparent and relevant measurement approach to reflect the economic values of loan assets within the financial statements? N=1,100*

