

An EDHEC Risk and Asset Management Research Centre and
EDHEC Financial Analysis and Accounting Research Centre Publication

Reactions to an EDHEC Study on the Fair Value Controversy

December 2008





Table of Contents

Introduction	5
1. Presentation of the EDHEC Call for Reaction	9
2. Analysis of Responses.....	13
3. Conclusion	21
Appendix 1: The Questionnaire	24
Appendix 2: Responses to Call for Reaction by Group.....	25
About the EDHEC Risk and Asset Management Research Centre.....	30
About the EDHEC Financial and Accounting Research Centre.....	32

About the Authors



Noël Amenc is professor of finance and director of research and development at EDHEC Business School, where he heads the EDHEC Risk and Asset Management Research Centre. He has a masters in economics and a PhD in finance and has conducted active research in the fields of quantitative equity management, portfolio performance analysis, and active asset allocation, resulting in numerous academic and practitioner articles and books. He is associate editor of the *Journal of Alternative Investments* and a member of the scientific advisory council of the AMF (French financial regulatory authority).



Frédéric Ducoulombier has been a full-time faculty member of EDHEC Business School since 2002. He currently serves as deputy to the school's director of research and heads EDHEC Asset Management Education. Over the last ten years, he has held positions in programme design, management, and internationalisation, and has taught finance in France and China. At EDHEC, he has unified the operations of the various MSc courses and now helps implement the school's innovative research policy. He joined the EDHEC Risk and Asset Management Research Centre in late 2004 to launch its executive education operation which now serves hundreds of organisations throughout Europe. As head of the centre's real estate research initiative, he has written in trade publications about real estate indices and derivatives and presented at various industry conferences. He holds an MSc in management from Léseg School of Management and a graduate certificate in East Asian Studies from Université de Montréal/McGill University as well as the Chartered Alternative Investment AnalystSM designation.



Philippe Foulquier, PhD, is professor of finance at EDHEC and director of the EDHEC Financial Analysis and Accounting Research Centre. After having begun his career at UAP, he spent ten years as a financial analyst specialised in the insurance industry. Before joining EDHEC in 2005, he led a pan-European team of insurance industry financial analysts at Exane BNP Paribas. He was several times named the best insurance industry financial analysts in the Extel/Thomson Financial rankings and by the *Agefi*. At EDHEC, his research revolves around the impact of IFRS and Solvency II on insurance company management and on company valuation. He is the co-author of a detailed study on the subject and has contributed to several CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) consultations. He has published several articles in professional reviews and his work has been mentioned by the *Financial Times* and the *Economist*. He is a member of the accounting and financial analysis committee of the *Société Française des Analystes Financiers* (SFAF). He has a doctorate in economic sciences from the Université de Paris X Nanterre, a master's in banking and finance, and a diploma from the SFAF.

Introduction

The threat to global financial stability posed by the credit crisis has led to a large-scale international mobilisation. Accounting rules, as it happens, are not unaffected by this mobilisation. Indeed, in October 2007, the G-7 finance ministers and central bank governors asked the Financial Stability Forum¹ (FSF) to undertake an analysis of the causes of the crisis and to make recommendations² for responding to it. Six months later, the FSF (FSF 2008a) made public its recommendations, some of which had to do with accounting standards: 1) improve treatment and transparency of off-balance sheet vehicles, 2) offer more guidance on pricing of financial instruments in inactive markets, and 3) require better information on pricing methods and on the sensitivity of valuations to assumptions and inputs.

With the worsening of the crisis over the summer of 2008, governments in Europe and North America reached a consensus: to restore confidence they intended to strengthen the global banking system and protect bank depositors. There were then numerous government interventions and governments continue working together to restore a minimum of confidence and stability to financial markets. On 22 September 2008, the G-7 finance ministers requested implementation of the FSF recommendations.

At the same time, the number of critics of fair value accounting has continued growing. The two major grounds for complaint are its pro-cyclical nature and the insufficient information provided by the standard setters on the means of valuing financial instruments in inactive markets. Their backs against the wall, the FASB and

the IASB³ raced to make amendments to their standards.

On 30 September, the SEC⁴ and the FASB were the first to issue additional guidelines (SEC 2008) for valuing assets in inactive markets. Under pressure from the European Commission and the European Parliament, which were threatening a new carve out, the IASB prepared amendments to IAS 39 and IFRS 7.⁵

On 3 October, the international standard setter underscored the need to avoid distortions in the competition with American banks. So the proposed modifications had to be consistent with the clarifications made by the SEC and the FASB and they had to make it possible to reduce the divergences in the principles set out by US GAAP⁶ and IFRS⁷ for the reclassification of assets. In its guidelines for the European Union, ECOFIN⁸ likewise took into account this necessary convergence of the two international standard setters (Council of the European Union 2008).

So as not to delay the adoption of these amendments by the European community, the board of the IASC Foundation⁹ announced on 9 October that it was actually suspending due process for the development and revision of standards. This decision made possible the publication of the amendments by the IASB on 13 October, approval on the following day by the EFRAG,¹⁰ and adoption by the European Commission on 16 October (EC regulation 1004/2008).

So, to allow financial institutions (mainly banks) to lessen the impact of the current crisis on the accounts published in the

1 - "The FSF brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. It was established by the G-7 Finance Ministers and Central Bank Governors in 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance" (FSF 2008b).

2 - The findings and recommendations in this report are the product of an intensive collaborative effort of the main international bodies and national authorities in key financial centres. They draw on a large body of coordinated work, comprising that of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Joint Forum, the International Accounting Standards Board (IASB), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and national authorities in key financial centres.

3 - Financial Accounting Standards Board (FASB); International Accounting Standards Board (IASB).

4 - Securities and Exchange Commission.

5 - IAS 39—Financial Instruments: Recognition and Measurement; IFRS 7—Financial Instruments: Disclosures.

6 - United States generally accepted accounting principles.

Introduction

7 - International financial reporting standards.

8 - The Economic and Financial Affairs Council, commonly known as ECOFIN, is made up of the economy and finance ministers of the member states of the European Union; it includes ministers overseeing the budget when budgetary matters are on the agenda.

9 - International Accounting Standards Committee Foundation. This foundation is the legal entity under which the IASB operates.

10 - European Financial Reporting Advisory Group.

11 - The IASB acknowledged that the current crisis could qualify as an extraordinary circumstance of the sort for which IAS 39.50.B made provisions.

12 - In a 1 October 2008 survey of its European members, the CFA found that a large majority of them (79%) were against the suspension of fair value and that 85% thought that a reform of that sort would heighten mistrust of the European banking system. This survey did not rely on the text of the amendments subsequently made by the IASB, which, to be sure, does not suspend fair value but reduces its reach considerably.

third quarter of 2008, it is now possible, on certain conditions, to reclassify some assets; IAS 39.50 had hitherto prohibited any reclassification of assets in the held for trading category. In particular, the changes provide for the following:

- Assets (shares and debt securities) other than loans and receivables hitherto classified as assets held for trading can be reclassified as available for sale (AFS) or held to maturity (HTM) in the event of extraordinary circumstances (IAS 39.50.B).¹¹ All the same, reclassification as held for trading remains prohibited, and shares can still not be classified as HTM. Finally, unlike FAS 155 (US GAAP), this amendment excludes the reclassification of derivatives and assets registered under the fair value option (a large share of insurance company assets not classified as available for sale and some non-synthetic bank CDOs). The financial institutions subject to IFRS immediately began lobbying for a new amendment to bring the two sets of accounting standards (international and US) into line and take another look at the restriction having to do with the fair value option.

- Assets classified as held for trading or AFS may be reclassified as loans and receivables if they are in fact loans and receivables (that is, non-derivative assets with fixed or set payments, not listed on active markets, and free of a risk of substantial loss not linked to the deterioration of credit risk) on the date of the reclassification and if the company is willing and able to hold them for the foreseeable future or until their maturity (IAS 39.50.D and E). Most asset-backed securities (ABSs), residential mortgage backed securities (RMBSs) and other debt securities as well as such structured products as collateralised debt obligations (CDOs)

can thus be reclassified as loans and receivables. The reclassifications must take place at the fair value of the assets on the date of reclassification. This fair value thus becomes the new value and prohibits the reporting of any income gains and losses that took place prior to reclassification. Since the publication of these amendments, and as a result of a request from the European Commission, a panel of experts from banks, insurance companies, and supervisory bodies has been studying possible complementary amendments along with the IASB.

In a recent position paper, the EDHEC Financial Analysis and Accounting Research Centre (Escaffre *et al.* 2008) studies the relevance of the critiques of fair value accounting. Its main conclusion is that the debate around the reform to fair value accounting misses the point, as it lumps together the role of accounting as a source of information and the prudential role of Basel rules for bank capital. Even if fair value accounting leads to a cyclical weakening—justified by the crisis—of the capital of financial institutions measured in fair value terms, it is not the accounting standard setter's job to estimate the amount of additional capital needed or to call for a curtailment of business activity. That is the regulator's job. Accounting is but one of the means of studying the risk profile of a financial institution; it does not have a prospective role.

The amendments to IAS 39 and IFRS 7 have been rather well received by financial institutions, although they would have liked to see even greater changes. By contrast, the users of financial statements, institutional investors and managers, in particular,

Introduction

have not been formally asked about the advantages and risks of these reforms.¹²

As it happens, the objective of our call for reaction was to shed light on investor views of these amendments, not just in the light of the conclusions of our position paper, but also in view of the ambitions of these reforms prepared and adopted in the greatest haste.

12 - In a 1 October 2008 survey of its European members, the CFA found that a large majority of them (79%) were against the suspension of fair value and that 85% thought that a reform of that sort would heighten mistrust of the European banking system. This survey did not rely on the text of the amendments subsequently made by the IASB, which, to be sure, does not suspend fair value but reduces its reach considerably.

Introduction

1. Presentation of the EDHEC Call for Reaction



1. Presentation of the EDHEC Call for Reaction

The aim of the EDHEC survey is to elicit from investors responses to the following questions:

- Have the amendments to IAS 39 and IFRS 7 attained their ultimate objective, which is to restore investor confidence?
- Are these changes to accounting rules likely to provide a suitable response to the deterioration of bank solvency?
- How are these amendments viewed by the users of financial statements? What are the arguments put forward to evaluate the effects of the reform?
- Ultimately, to what extent do these accounting reforms address the criticism that was the reason for their adoption, that is, the criticism of the pro-cyclicality of IFRS?

To determine whether the respondents to our call for reaction are representative of the industry, we also ask them where they are based and what branch of the industry they work in. The questions are shown in appendix 1.

We describe below the method used to draw up this questionnaire, in particular our reasons for posing the questions the way we do.

Have the amendments to IAS 39 and IFRS 7 attained their ultimate objective, which is to restore investor confidence?

To respond to the crisis and restore investor confidence, European authorities and the accounting standard setters considered it opportune to allow financial institutions to return, for some of their transactions, to accounting treatment at historical cost.¹³ This return does indeed

make it possible to reduce the volatility in financial statements, in particular that of net income. So it seemed important to us to determine whether these amendments have in fact achieved their goal; to do so, we first determine the extent of investor awareness of these reforms.

Are these changes to accounting rules likely to provide a suitable response to the deterioration of bank solvency?

The opponents of fair value accounting criticise its pro-cyclical nature. When the equity capital of banks falls considerably, their solvency margins become sligher, a change that can cause them to sell certain assets and/or to curtail business activity. For this reason, fair value accounting is sometimes accused of being responsible for the additional capital required by prudential rules. If investors take this view, that is, if they think that a smaller fall in *accounting* income is likely to restore the *economic* solvency of banks, these amendments will indeed restore their confidence.

Studies such as that of the IMF (2008) show that fair value accounting is appropriate, especially to reflect the current exposure to risk of financial institutions. All the same, the IMF recognises that in periods of turbulence, this transparency brought about by fair value can exacerbate cyclical movements. It is likely to cause great volatility in the balance sheet. It can thus lead to a tightening of the terms for awarding credit during economic slowdowns, when credit has a major role to play. Nonetheless, this report emphasises that other accounting systems (historical cost,

13 - Historical cost here is understood as the value of the instrument observed or estimated at the moment of its classification.

1. Presentation of the EDHEC Call for Reaction

14 - The smoothing of losses and their late recognition in accordance with the principles of accounting at historical cost make it impossible to gauge the risks of financial institutions correctly. So historical cost does not encourage the entry, on solid economic grounds, of new investors with fresh capital. In addition, accounting at historical cost tends to retard the resolution of the crisis, as was the case for the great banking crisis of the 1990s in Japan. Finally, the accounting systems that assign treatments to instruments depending on holding intentions and/or those systems that authorise a posteriori reclassifications are counter-cyclical, as they make it possible to limit the depreciation of the assets of banks and financial institutions as reported in the accounts. Such mechanisms, however, are likely not only to heighten investor distrust of the quality of information available in financial statements, but also to create incentives to take excessive risks, as a result of the asymmetry of treatments for gains and losses.

for example) are not necessarily likely to prevent these problems;¹⁴ it is simply that fair value recognises them as they appear. It is thus necessary for the quality of the information found in the appendices to improve, so that the users of financial statements may undertake a better valuation of the real exposure to risks.

The conclusion of the EDHEC position paper (Escaffre *et al.* 2008) does not stop at this analysis; it argues that there is a confusion of roles. Accounting is but one of the means to assess the risk profiles of companies, and the decisions of regulators should be founded as well on the ability of financial institutions to recover in the near future, on their real exposure to the crisis, and, more broadly, on the ability of management to turn things around. This prospective dimension does not fall within the province of accounting. So the amendments authorising a return to historical cost may be viewed as being at odds with their objectives. Indeed, this approach to accounting is likely to smooth or even conceal real risk exposures and, as a result, to heighten investor mistrust of the figures published in financial statements. Historical cost, in short, affords companies the opportunity for greater discretionary management of the accounts without at the same time improving their economic solvency.

In general, are these amendments considered appropriate by investors?

We ask a set of questions in an attempt to determine whether these amendments are viewed by respondents in a negative or positive light. We also thought it necessary to understand the reasons

for which the respondents view the amendments as appropriate (accounting or economic reasons) or as ineffective (or even dangerous). So we offer a series of possible responses corresponding to the critiques of fair value that ultimately led to these amendments. We highlight the arguments of both opponents and defenders of fair value.

Do these accounting reforms address the critiques that were the reason for their adoption?

A final question gauges whether respondents believe these amendments address the major critiques that were the reason for their adoption by the European Commission. Have they achieved their objective in terms of the awareness of the pro-cyclicality of accounting? Have they had a positive impact on the crisis or are they likely to worsen it by making financial information less readable?

2. Analysis of Responses



2. Analysis of Responses

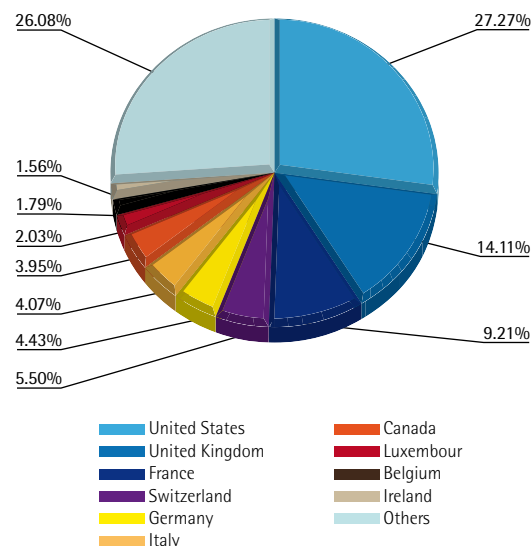
15 - Detailed responses for each group of respondents are shown in appendix 2.

This section presents the responses to the EDHEC call for reaction (see appendices 1 and 2). The objective is to analyse views of the amendments to IAS 39 and IFRS 7 and to study them in the light of the arguments made by EDHEC in its above-mentioned position paper (Escaffre *et al.* 2008).

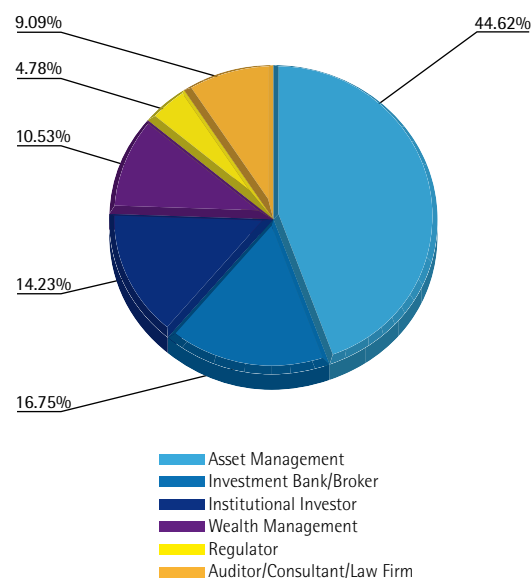
The questionnaire elicited responses from 836 respondents of heterogeneous backgrounds, as shown by the two charts below. Nearly one-third of respondents are from North America, one-fourth from continental Europe, 15% from the United Kingdom, and another one-fourth from the rest of the world. More than two-thirds are asset managers of one form or another (45% third-party asset managers, 14% institutional investors, and 11% wealth managers). Investment bankers/brokers (17%), regulators (9%), and auditors/consultants/lawyers (9%) together account for the other third of respondents.

Analysis of the deviations in the responses from one group of respondents to another shows that these deviations are not statistically significant. In other words, contrary to conventional wisdom, there are no pronounced differences from one group of account users to another, and the opinion of the number crunchers is not biased by a conflict of interest that might encourage them to take up the defence of fair value to the detriment of the interests of other parties.¹⁵

Breakdown by country and by profession of respondents
% of 836 respondents



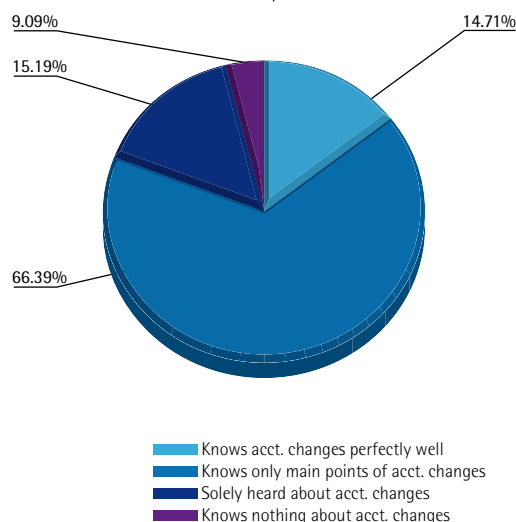
Business Activity
% of 836 respondents



2. Analysis of Responses

More than 80% of those who respond to the call for reaction report in their answers to our first question that they are familiar with the main points of the accounting changes. 15% of our sample report that they know the changes perfectly well. This great familiarity shows that the respondents to the questionnaire consider themselves affected by these changes to IAS 39 and IFRS 7 and that they were eager to react to the changes made by the International Accounting Standards Board.

Knowledge of changes made by international Accounting Standards Board – % of 836 respondents



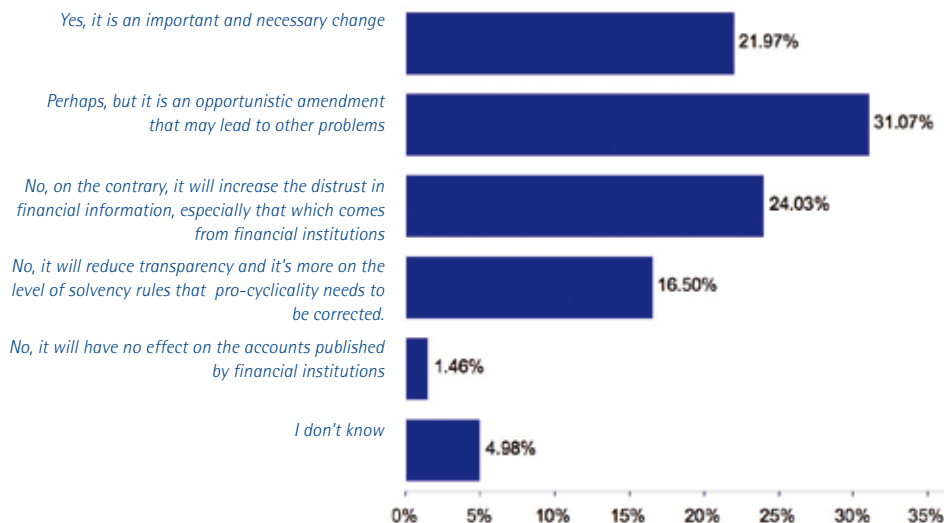
In our second question, we ask those responding to the call for reaction if they believe that the IASB reforms are likely to be a genuine solution to the solvency crisis in the financial system and for banks.

Only 22% of respondents report that they consider these amendments an important and necessary change. The following question will allow us to identify the main arguments advanced by these respondents for their support of these accounting changes.

In addition, it is worth noting that only 1.5% of respondents believe that these amendments will have no effect on the accounts published by financial institutions. Nearly one-third of respondents, by contrast, are unsure as to the effectiveness of these amendments as a means of restoring solvency, and they consider them opportunistic and likely to lead to other problems.

In short, and here EDHEC's analysis is corroborated, nearly three-quarters of respondents (72%) note that these

Do you think that this reform, which the EU leaders and finance ministers called for as a response to the crisis, represents a genuine solution to the deterioration of the solvency in the financial system, and notably in banks? % of 824 respondents



2. Analysis of Responses

amendments could be the source of new problems: mistrust of financial information (24.03%), reduced transparency (16.3%). As it happens, it is our belief that the debate on the putative role of fair value accounting in the exacerbation of the crisis misses the point.

The opponents of fair value accounting have failed to consider the problem farther upstream, that is, they have failed to acknowledge the role of accounting. The role of accounting is to provide as reliable a description as possible of the net assets of a company at a given time, in the environment prevailing at the moment of the statement of the accounts. It is meant to provide information, not to be a source of prudential rules. Returning to historical cost would, in our opinion, be likely to conceal the real risk exposure of companies and exacerbate the mistrust of the financial community. Indeed, one wonders about the quality of information that will be provided by 2008 financial statements that will have relied on a valuation of debt securities—reclassified *a posteriori* in the banking book—at July 2008 levels.

The advantage of the measures mentioned by the greatest share of respondents

(29.51%) is that, in periods of crisis, these measures would make it possible to work around the problems posed by accounting for financial instruments at fair value. This response is interesting in that it mirrors one of the major arguments for the reform put forward by the G-7 finance ministers and by most governments.

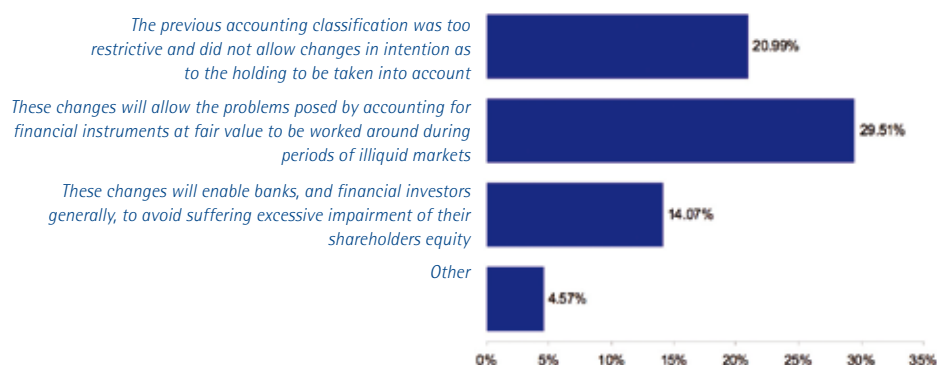
But it should be noted that there has lately emerged real confusion on the definition of an asset at far value in times of crisis. Some have criticised fair value accounting by arguing that, in an inactive market, IFRS forced recognition of assets at distress-sale prices (forced liquidation), the last known price on the market. It was not until 10 October 2008 that the Expert Advisory Panel, commissioned by the IASB, stated that distress sales (forced liquidations) should not be included in the assumptions used to determine fair value. The EDHEC call for reaction was distributed shortly after this date; it is possible that the matter was still unclear for some respondents.

It is worth recalling that in inactive markets, entities must acquire a complete and reliable understanding of the instrument that is subject to a measurement of fair value by considering all the available relevant

Advantages of measures

In % of answers to questions 3.1 and/or 3.2* (multiple answers possible)

810 answers: question 3.1 being the "advantages of measures", question 3.2 being the "drawbacks of measures"



2. Analysis of Responses

information. Information to be considered includes:

- prices from recent transactions in the same or similar instruments (IASB 2008, paragraphs 37-46)
- quotes from brokers and pricing providers (databases) (IASB 2008, paragraphs 52-74)
- indices and other input to model-based valuation techniques (IASB 2008, paragraphs 47-51).

If information on prices is unsatisfactory because it comes from a totally disorganised or inactive market, a mark-to-model valuation should be used. So, in inactive markets, an entity should determine its best estimate of fair value within a documented range of measurements that should be grounded on the following:

- measurement on the basis of a recent transaction in an active market in the same financial instrument
- measurement of fair value on the basis of the valuation of a similar financial instrument
- modelling on the basis of observable or unobservable input.

But fair value is not the amount the entity would receive or pay in a distress sale or forced liquidation.

The advantage chosen by the second-largest percentage of respondents (20.99%) in favour of the amendments to IFRS has to do with the provisions made by these amendments for changes in intention in the holding of assets.

This argument, used by some of the opponents of fair value, seems altogether spurious to us. Would banks really

have suddenly and en masse changed their intentions with respect to debt securities? Let us recall that some financial instruments (certain CDOs, for instance) had been classified as held for trading (a classification approved by the standard setters) despite features that made them altogether inappropriate for trading. Indeed, many CDOs were created to meet the demands of particular investors. For that reason, they are not meant to be traded and it is hard to determine a transaction price for them (absence of a secondary market). Banks had chosen this classification for no other reason than to exploit arbitrage opportunities made possible by prudential regulations. As it happens, the classification of these instruments in the trading book rather than in the banking book allowed banks to reduce their capital requirements (by ignoring counterparty and liquidity risks). So it is more of a failing of the prudential framework than an accounting problem. In a sense, the decision to allow the reclassification of these assets rewards inappropriate risk management and financial reporting practices.

The advantage chosen by the third-largest group (14.07%) of those in favour of the amendments is that they may prevent excessive depreciation of assets and impairment of shareholders' equity. During the debates on these amendments, the argument that they would smooth the impact of the financial crisis on the profit and loss account and reduce volatility in financial markets was invariably trotted out. But in EDHEC's view—and we will return to this point in the following question—this measure is likely to reduce the role of accounting

2. Analysis of Responses

as a source of information and to heighten investor mistrust of the accounts.

The question on the drawbacks of the reform mirrors the question on the advantages. The aim is to shed light on the reasons for which the respondents who are against the reform take the position that they do.

39.26% of the respondents not in favour of these measures report that these accounting changes are likely to give a less accurate view of a company's risks; 31.98% mention that companies will have more room for discretionary decisions and that accounts will be easier to manipulate; 31.85%, finally, mention that these measures will make it harder to compare companies.

It is worth noting that the first two arguments are implicitly close to the argument that, in the preceding question, was considered an advantage (the ability to reduce recognition of depreciation). This difference in perceptions is, to be sure, associated primarily with the status of the respondent (preparer or user of financial statements).

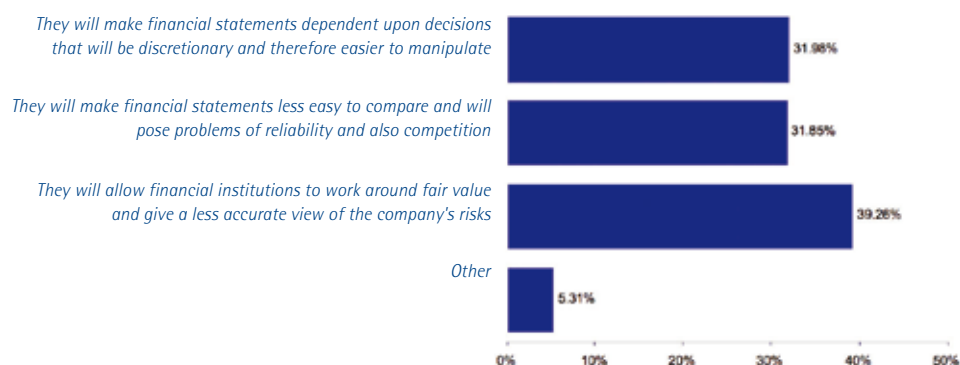
Ultimately, there are arguments for and against the amendments made by the IASB, but the relative weight of those against it is greater. Indeed, the relative weight of respondents' arguments in favour of the reform is no greater than 39%, whereas the weight of those against it amounts to 61%.

This negative reaction from investors, managers, and, more broadly, from the users of financial statements, is in keeping with the aim of the implementation of international financial reporting standards and the general role assigned accounting.

The amendments adopted in haste¹⁶ by the IASB are a counter-productive response to the serious financial crisis we are experiencing. Cutting down on the information provided by financial statements by suspending fair value accounting is likely to exacerbate the current crisis of confidence.

16 - The usual due process, involving debate with, among others, the users of financial statements, was not respected, with the agreement of the Trustees.

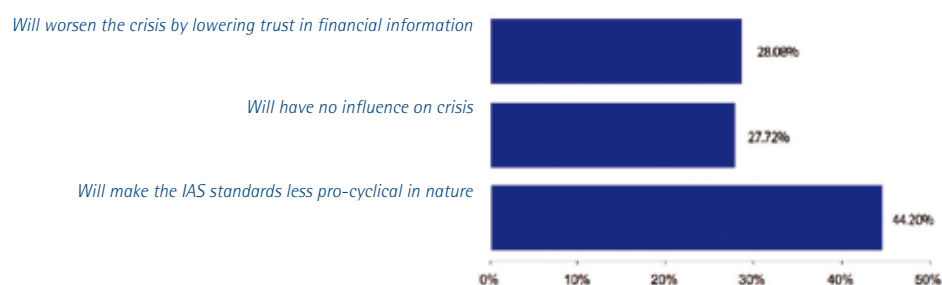
*Drawbacks of measures
In % of answers to questions 3.1 and/or 3.2* (multiple answers possible)
810 answers question 3.1 being the advantages of measures, question 3.2 being the drawbacks of measures*



2. Analysis of Responses

The final question attempts to shed light on the respondents' overall assessment of the accounting amendments.

Overall judgment of changes (in % of answers to question)



It would hardly have been unreasonable to expect that the turmoil in which financial institutions find themselves and the risks that are weighing on the banking and financial system would, for our respondents, justify measures that could be criticised but were an indispensable response to the downturn. But, as the responses show, this is not the case: the respondents are aware of the dangers of this accounting reform and its unsuitability as a response to the crisis. Less than half of the respondents to the call for reaction (44.20%) think that these amendments will make the standards less pro-cyclical. 27.72% report that they think the changes may even worsen the crisis by making financial information less trustworthy.

3. Conclusion



3. Conclusion

17 - This increase was required even though in some countries, including France, the threshold that set off the increases had been raised considerably.

The responses to our call for reaction corroborate the arguments made in our EDHEC position paper (Escaffre *et al.* 2008) on the amendments to IAS 39 and IFRS 7 adopted by the IASB in mid-October 2008. Less than one-fourth of our respondents believe that these amendments are necessary and well suited to resolving the problems of bank solvency; indeed, three-fourths of respondents believe that they are likely to lead to new problems.

In addition, only 44.2% of those who respond to the call for reaction think that these amendments are likely to reduce pro-cyclicality. 27.7% think they will have no effect whatsoever on the crisis and 28.1% think that they could worsen the crisis by making financial information less trustworthy.

Ultimately, this call for reaction strengthens EDHEC's arguments against the changes made in haste by the IASB. As it happens, EDHEC believes that the debate on the reform to the accounting framework misses the point, as it confuses the role of accounting as a source of information and the prudential role of Basel rules for bank capital. Even if fair value accounting leads to a cyclical weakening—justified by the crisis—of the fair value of the equity of financial institutions, it is not the accounting standard setter's job to estimate the amount of additional capital needed or to call for a curtailment of business activity. That is the role of the regulator. Accounting is but one of the means of discerning the true risk profile of a company; its role is not prospective.

In addition, by making it possible on certain conditions, to treat at historical

cost transactions initially treated at fair value (amendments to IAS 39, in particular), financial statements contain less and perhaps even erroneous information: historical cost makes it easier to smooth and to manage the accounts in a discretionary way. Such practices are likely to conceal real risk exposure and heighten the mistrust of the financial community, without providing any real benefit to the financial institutions that resort to them.

It is worth recalling too that, despite the historical cost approach in favour during the financial crisis of 2000–2003, many insurers were forced to sell off a part of their stock portfolios, at the height of the gale, to put an end to the increase in provisions for durable depreciation.¹⁷ The insurers thus needed several injections of capital to restore their solvency margins. At the time, the pro-cyclical nature of accounting (at historical cost though it was) had already been pointed out.

All the same, we do not by any means consider the current accounting framework altogether satisfactory. On the contrary, we believe that IFRS includes many provisions that are odds with solid risk management practices for banks, insurers, and companies in general. Our critiques of these problems, which we pointed out as early as 2006 (Amenc *et al.* 2006; Foulquier and Touron 2008), are grounded on the fact that, all too often, the accounting treatments adopted by the IASB are at odds with its objective: to provide a better reading of exposure to risks (independently of fair value, which, in our opinion, provides the greatest transparency, although more guidance from standard setters would improve things).

3. Conclusion

Profound reform is necessary to keep IFRS from discouraging appropriate risk management practices. In particular, the accounting treatments proposed by the IASB for IAS 39 lead to artificial accounting volatility in the profit and loss account and/or in equity capital, volatility that makes it hard to hedge with derivative instruments or manage asset and liability risks dynamically. In addition, the limits of the fair value option and the dissuasive character of the HTM classification make it impossible to work efficiently around the problems posed by the dichotomy between the pricing of the assets and the liabilities of financial institutions.

By the same token, we believe that the temporary solution (IFRS Phase 1) put in place by the IASB for the insurance industry is an altogether unsatisfactory response to the failure of the accounting standard setter—and of prudential regulators most of all—to make proper allowances for asset/liability management. The result is so-called shadow accounting entirely altogether incompatible with the objectives of transparency and the reporting of the financial risks financial institutions are exposed to.

These critiques of IFRS and of the proposed reforms should by no means lead the IASB, under pressure from governments though it may be, to a hasty impugning of fair value itself. They are instead grounds for calm and reasoned debate, debate founded on an overview of the uses of current standards, the outcome of which should be an improved understanding of the economic reality and the practices of companies.

Appendix 1: The Questionnaire

On 13 October 2008 amendments were made to the IAS 39 and IAS 7 accounting standards, notably allowing the reclassification of some financial assets that were initially accounted for at fair value through the profit and loss account. As an investor or asset manager, we wished to gather your reactions to this reform.

1. Do you know the details of the changes made by the International Accounting Standards Board?

- Yes, perfectly well
- Yes, but only the main points
- I've heard about them but I'm not aware of the nature of the changes
- Not at all.

2. Do you think that this reform, which the EU leaders and finance ministers called for as a response to the financial crisis, represents a genuine solution to the deterioration of solvency in the financial system, and notably in banks?

- Yes, it is an important and necessary change
- Perhaps, but it is an opportunistic amendment that may lead to other problems
- No, on the contrary, it will make financial information less trustworthy, specifically that which comes from financial institutions
- No, it will reduce transparency and it's more on the level of solvency rules that pro-cyclicality needs to be corrected
- No, it will have no effect on the accounts published by financial institutions
- I don't know

3. Do you think that these are good measures? Yes. Please give the reasons:

- The previous accounting classification was too restrictive and did not allow changes in intention as to the holding of financial instruments to be taken into account
- These changes will allow the problems posed by accounting for financial instruments at fair value to be worked around during periods of illiquid markets
- These changes will enable banks, and financial investors generally, to avoid suffering excessive impairment of their shareholders' equity
- Other. Please specify.

3. Do you think that these are good measures? No. Please give the reasons:

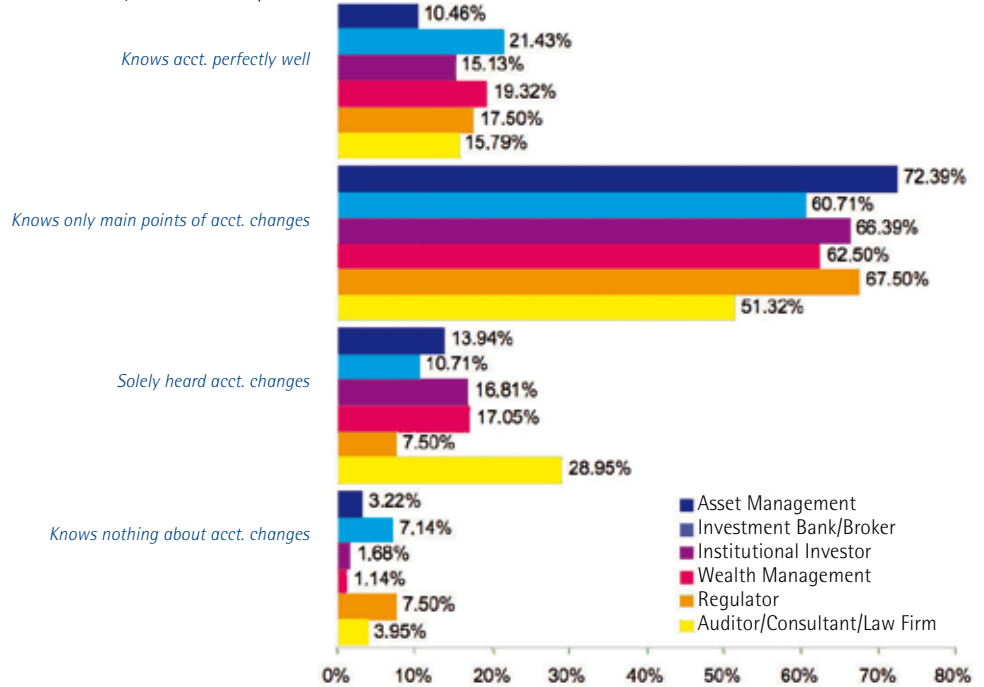
- They will make financial statements dependent upon decisions that will be discretionary and therefore easier to manipulate
- They will make financial statements less easy to compare and will pose problems of reliability and competition
- They will allow financial institutions to work around fair value and give a less accurate view of the company's risks
- Other. Please specify.

4. Overall, do you think that these changes

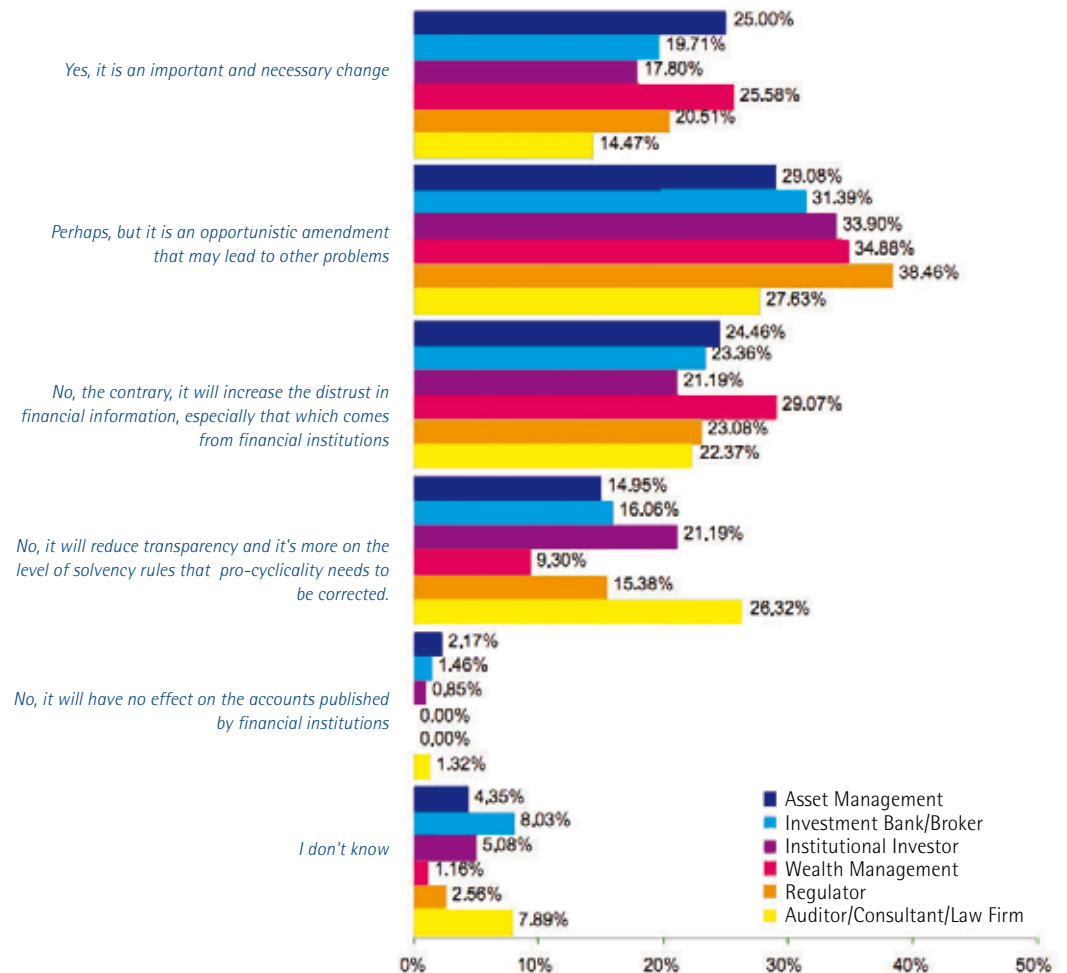
- Will make the IAS standards less pro-cyclical in nature?
- Will have no influence on the crisis?
- Will worsen the crisis by making financial information less trustworthy?

Appendix 2: Responses to Call for Reaction by Group

Knowledge of changes made by international Accounting Standards Board
In % of business activity* - 836 answer pairs



Do you think that this reform, which the EU leaders and finance ministers called for as a response to the crisis, represents a genuine solution to the deterioration of the solvency in the financial system, and notably in banks? % of 824 respondents

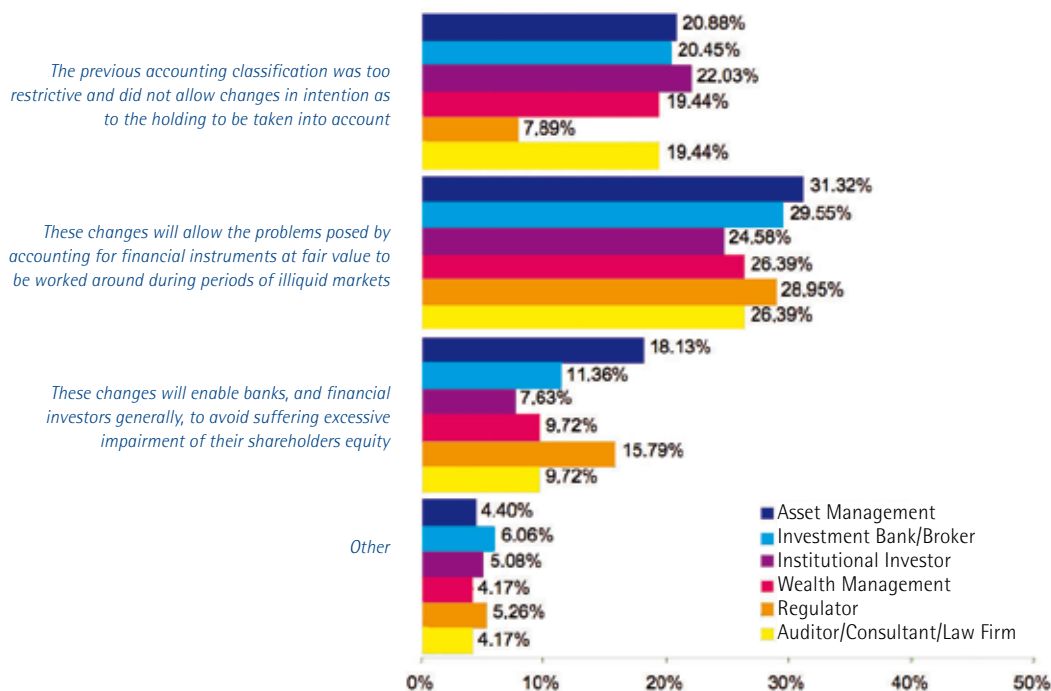


Appendix 2: Responses to Call for Reaction by Group

Advantages of measures

In % of answers to questions 3.1 and/or 3.2* (multiple answers possible)

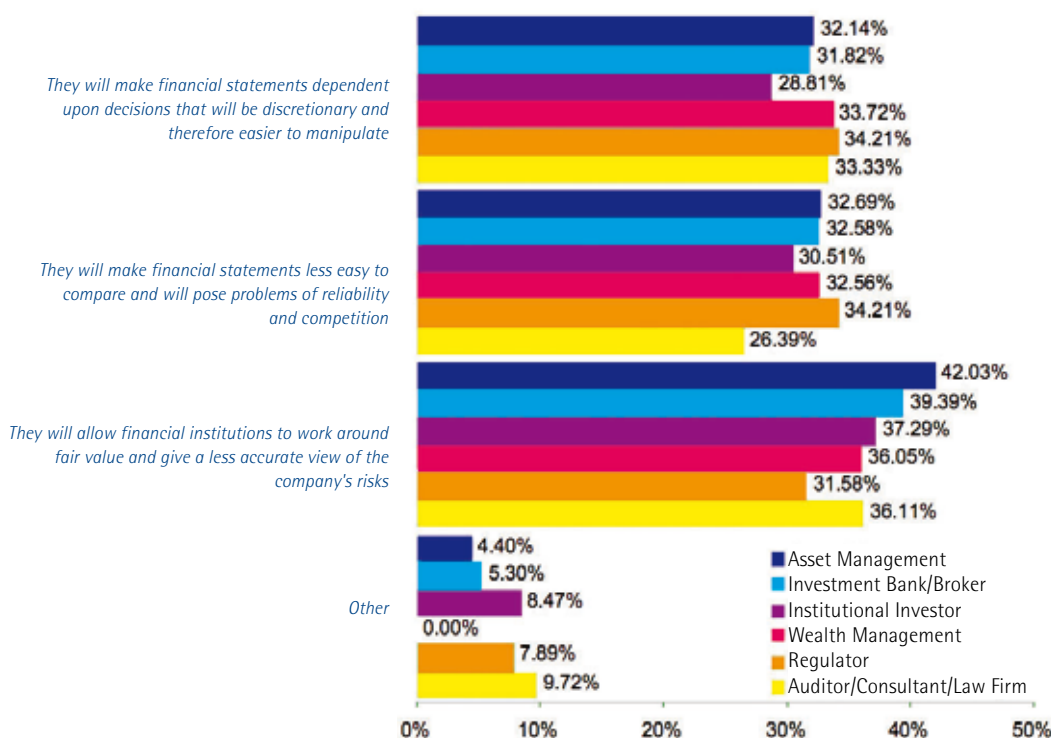
810 answers: question 3.1 being the "advantages of measures", question 3.2 being the "drawbacks of measures"



Drawbacks of measures

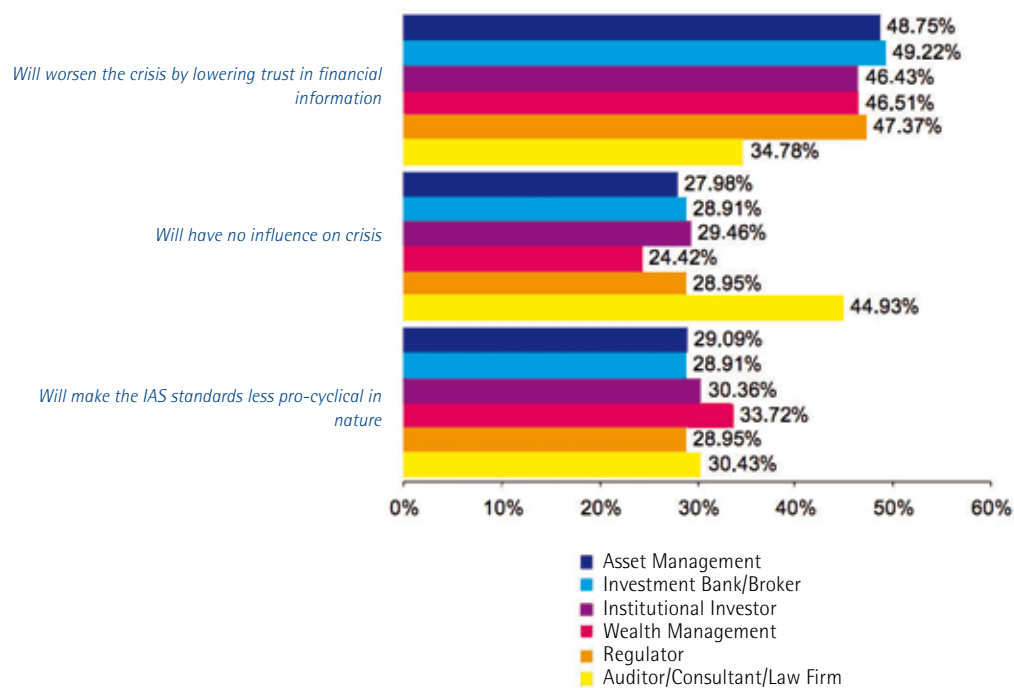
In % of answers to questions 3.1 and/or 3.2* (multiple answers possible)

810 answers question 3.1 being the advantages of measures, question 3.2 being the drawbacks of measures



Appendix 2: Responses to Call for Reaction by Group

Overall judgment of changes (% of answers to question)



References

- Amenc, N., P. Foulquier, L. Martellini, and S. Sender. 2006. The impact of IFRS and Solvency II on asset-liability management and asset management in insurance companies. EDHEC Publication.
- Council of the European Union. 2008. Immediate responses to financial turmoil, Council conclusion – Ecofin Council of 7 October 2008. Press release (7 October).
- Escaffre L., P. Foulquier, and P. Touron. 2008. Juste valeur ou non : un débat mal posé. EDHEC position paper (November).
- Financial Stability Forum. 2008a. Report of the Financial Stability Forum on enhancing market and institutional resilience (11 April).
- —. 2008b. Financial Stability Forum recommends actions to enhance market and institutional resilience. Press release (11 April).
- Foulquier, P., and P. Touron. 2008. Dérivés et comptabilité de couverture : vers une (mé) connaissance des risques ? *Comptabilité, Contrôle, Audit* (forthcoming).
- IASB. 2008. IASB expert advisory panel: measuring and disclosing the fair value of financial instruments in markets that are no longer active (31 October).
- IMF. 2008. Financial stress and deleveraging macrofinancial implications and policy. *Global Financial Stability Report* (10 October).
- Securities and Exchange Commission. 2008. SEC office of the chief accountant and FASB staff clarifications on fair value accounting. Press release (30 September).

About the EDHEC Risk and Asset Management Research Centre

Since 2001, EDHEC has been pursuing an ambitious policy in terms of international research. This policy, known as "Research for Business", aims to make EDHEC an academic institution of reference for the industry in a small number of areas in which the school has reached critical mass in terms of expertise and research results.

Among these areas, asset and risk management have occupied privileged positions, leading to the creation in 2001 of a major European research facility: the EDHEC Risk and Asset Management Research Centre.

This centre now boasts a team of 32 permanent professors, engineers and support staff, as well as 18 research associates from the financial industry. The EDHEC Risk and Asset Management Research Centre has developed six major research programmes:

- Asset allocation and alternative diversification
- Indices and benchmarking
- Style analysis and performance measurement
- Best execution and operational performance
- Asset allocation and derivative instruments
- ALM and asset management

These programmes receive the support of several financial companies, both from within France and abroad, representing some thirty different sponsors (including AXA Investment Managers, Barclays Global Investors, BNP Paribas Investment Partners, Citigroup, CACEIS, Deutsche Bank, Fortis, Eurex, LODH, NYSE Euronext,

HSBC, Pictet, Robeco, Morgan Stanley, NewEdge, SG CIB, State Street, UBS, and many others).

In addition, EDHEC has developed a close partnership with a small number of sponsors within the framework of research chairs that correspond to a commitment over three years from the partner on research themes that are agreed in common. The following research chairs have been endowed to date:

- 'Regulation and Institutional Investment' in partnership with AXA Investment Managers (AXA IM)
- 'Asset-Liability Management and Institutional Investment Management' in partnership with BNP Paribas Investment Partners
- 'MiFID and Best Execution' in partnership with NYSE Euronext, SunGard and CACEIS Investor Services
- 'Structured Products and Derivative Instruments', sponsored by the French Banking Federation (FBF)
- 'Financial Engineering and Global Alternative Portfolios for Institutional Investors', in partnership with Morgan Stanley Investment Management (MSIM)
- 'Private Asset-Liability Management' in partnership with ORTEC Finance
- 'Dynamic Allocation Models and new Forms of Target Funds' in partnership with Groupe UFG
- 'Advanced Modelling Techniques for Hedge Fund Returns' in partnership with Newedge
- 'Asset-Liability Management Techniques for Sovereign Wealth Fund (SWF) Management' in partnership with Deutsche Bank

About the EDHEC Risk and Asset Management Research Centre

The philosophy of the centre is to validate its work by publication in international journals, but also to make it available to the sector through its Position Papers, published studies and conferences. Each year, EDHEC organises two conferences for professionals with a view to presenting the results of its research: EDHEC Alternative Investment Days (London) and EDHEC Institutional Days (Paris), attracting more than 2,000 professional delegates.

EDHEC also provides professionals with access to its research web site (www.edhec-risk.com), which has more than 25,000 regular visitors and which publishes a monthly newsletter that is e-mailed to more than 200,000 readers.

EDHEC's distinguished international faculty includes renowned researchers and professors in finance and economics whose work has appeared in the major academic journals worldwide, including Professor Noël Amenc, Professor René Garcia, Professor Pierre Mella-Barral, Professor Lionel Martellini, Professor Florencio López de Silanes and Professor Joëlle Miffre.

Tel.: +33 (0)4 93 18 78 24
Email: research@edhec-risk.com
www.edhec-risk.com

About the EDHEC Financial and Accounting Research Centre

The Financial Analysis and Accounting Research Centre was created in 2006 around the theme of company valuation. Cultural and technological changes now make it possible to use multiple dynamic analyses, the cornerstone of which is the discount rate. There is an abundance of academic research into the determination of the discount rate, but the gap between academe and business seems to be growing wider by the day. In practice, those who do the valuations often oversimplify, invalidating their reasoning; they may even ignore theory and transform the discount rate into a black box to hide the absence of objective and academic foundations in the determination of the risk premium and of beta.

The objective of the EDHEC Financial Analysis and Accounting Research Centre is to call into question certain financial paradigms, in particular that which consists of separating idiosyncratic risk—because it is diversifiable—from the risk premium and to provide the financial markets (financial analysts, investors, companies, rating agencies, auditors) with new light on the discount rate and to recommend new ways to determine it.

The great diversity of backgrounds is one of the advantages of the research centre (specialists in financial analysis, in accounting, in law, researchers from academe or from business), and it allows the centre to take a multi-disciplinary approach to financial analysis: company valuation, impact of IFRS and Solvency II on insurance companies, the impact of IFRS on the valuation and pricing of

risk, growing use of fairness opinions, the status of the outside expert, and the measurement of intangible assets.

Tel.: +33 (0)4 93 18 32 53

Email: joanne.finlay@edhec.edu

www.edhec.com/edhec-valuation

**EDHEC Risk and Asset Management
Research Centre**

393-400 promenade des Anglais

BP 3116

06202 Nice Cedex 3 - France

Tel.: +33 (0)4 93 18 78 24

Fax: +33 (0)4 93 18 78 41

E-mail: research@edhec-risk.com

Web: www.edhec-risk.com

**EDHEC Financial Analysis
and Accounting Research Centre**

393-400 promenade des Anglais

BP 3116

06202 Nice Cedex 3 - France

Tel.: +33 (0)4 93 18 32 53

E-mail: joanne.finlay@edhec.edu

Web: www.edhec.com