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**Effects of Global Financial Crisis on Fair
Value Accounting**

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Overview of the Presentation

- ❑ Part 1 – Overview of Global Financial Crisis (GFC)
- ❑ Part 2 – Use of Fair Value Accounting (FVA) in International Financial Reporting Standards (IFRS)
- ❑ Part 3 – Critics views towards FVA after GFC
- ❑ Part 4 – Impacts of issues in FVA on:
 - Regulation
 - Business Community

Part 1 – Overview of Global Financial Crisis (GFC)

What is a Financial Crisis?

“a variety of situations in which some financial institutions or assets suddenly lose a large part of their value”

The previous well known crisis are:

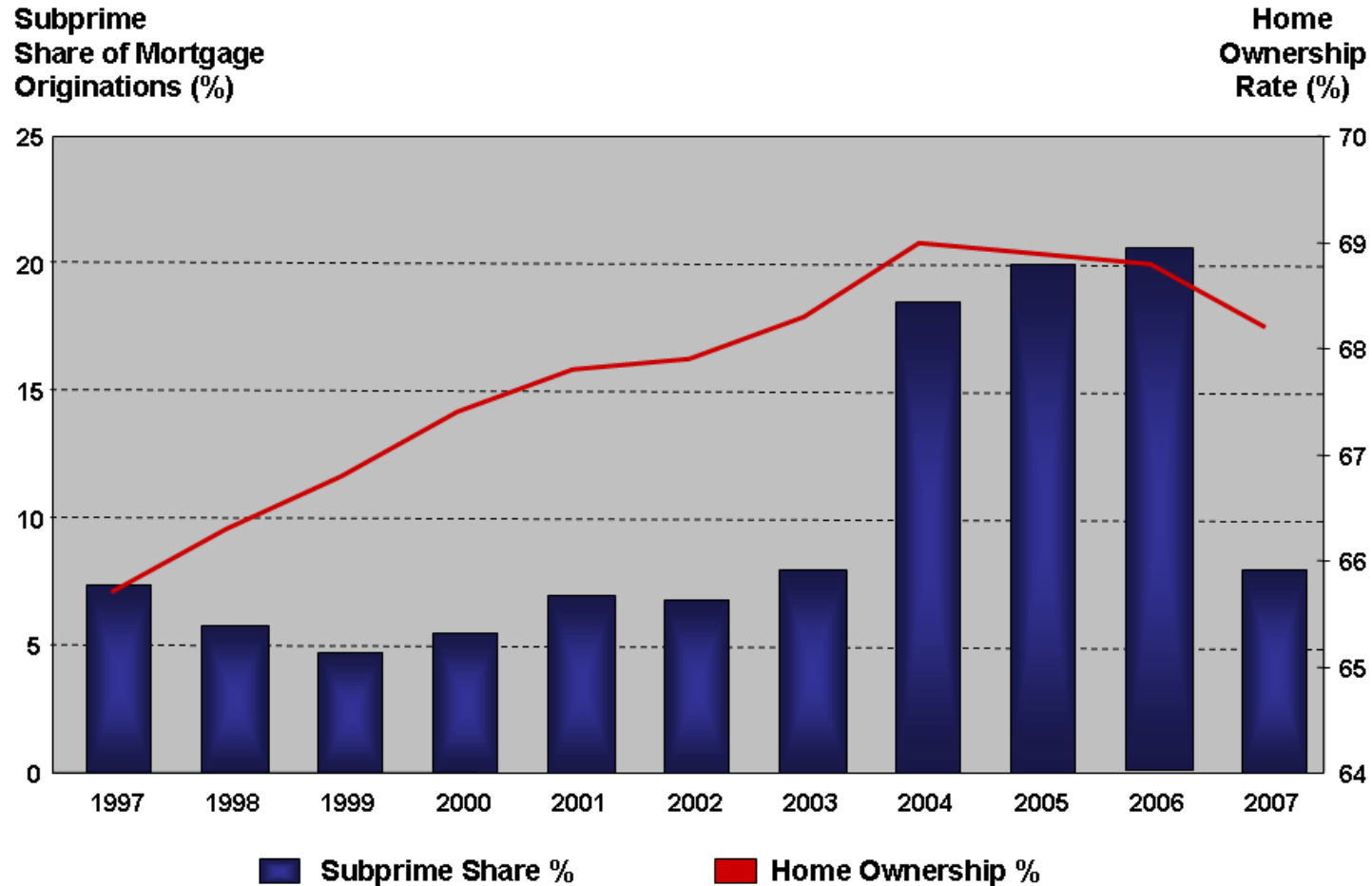
- 1930s: Great Depression
- 1980s: Latin American debt crisis
- 1997-1998: Asian Financial Crisis

Overview of Global Financial Crisis (GFC) con't

The First Global Financial Crisis of the 21st Century

- Began in July 2007
- Began with a **credit crunch** causing **liquidity crisis**
- **aggressive lending** by subprime mortgage industry
- **relaxed lending standards**

US Subprime Lending



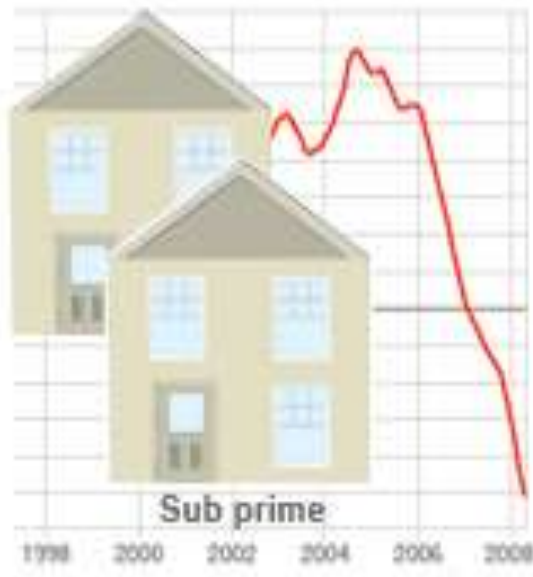
Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2008

US subprime lending expanded significantly from 2004-2006

Mortgage defaults lead to investment losses

SUB PRIME PROBLEMS

Mortgage defaults increase
Flow of money stops



Concern over asset-backed securities
Interbank lending stops



Overview of Global Financial Crisis (GFC) con't

September 2008 crisis worsened

- stock markets around the globe crashed and became volatile
- low or negative economic growth
- production levels low
- increased unemployment
- corporate collapses

Examples of Corporate collapses and bail outs



Primary causes of the GFC

- Sub-prime exposures in the US
- Overleveraging of the global economy
- Relaxed lending standards
- Unqualified borrowers
- Failed regulations
- Accounting standards

Was accounting standards responsible for the GFC?



Was FVA Responsible for the GFC?

➤ FVA – What is it?

Fair value is defined as “the amount for which an **asset could be exchanged** or a **liability settled between knowledgeable, willing parties in an arm’s length transaction**” (IFRS 3 *Business Combinations*, p.3).

➤ FVA is also known as “**Mark to Market**”.

Determining fair values

- **Active markets - (Level 1)** Use quoted prices
- **mark to market**
- **Observable inputs - (Level 2)** Use inputs that
are *observable*
- **Unobservable inputs - (Level 3)** Using inputs
that are *not based on
observable market data*
- **mark to model**

Part 2 – Use of FVA in IFRS

- IFRS brought in a revolution in accounting practices - **criticisms of Historical Cost Accounting (HCA)**
- Fair value was first mentioned in International Accounting Standards **(IAS) in 1977**, in the context of IAS 17 *Accounting for Leases*
- 1995 agreement of International Standards Committee (IASC) with International Organization of Securities Commission (IOSCO)
- 1999 – **Issue of IAS 39**
- 2003 – **amendments of IAS 32 and IAS 39** by IASB in favor of FVA

Requirements to use FVA in IAS/IFRS

- IFRS 2 *Share-based Payment*
- IFRS 3 *Business Combinations*
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- IAS 17 *Leases*
- IAS 18 *Revenue*
- IAS 19 *Employee Benefits* (for plan assets)
- IAS 20 *Government Grants*
- IAS 26 *Accounting and Reporting by Retirement Benefit Plans*
- IAS 39 *Financial Instruments: Recognition and Measurement*
- IAS 36 *Impairment of Assets*
- IAS 41 *Agriculture*

Options to use either FVA or HCA in IAS/IFRS

- IFRS 1 *First-Time Adoption of IFRS*
- IAS 16 *Property, Plant and Equipment*
- IAS 28 *Investments in Associates*
- IAS 38 *Intangible Asset*
- IAS 40 *Investment Property*

Part 3 – Critics views towards FVA after GFC

Fair value accounting – what went wrong?

- Determining the fair value of the inactive assets (**Model Noise**)
- FVA added to the **pro-cyclicality effect**
- FVA required companies to mark their financial instruments at market prices and can reflect the bad news unmercifully
- Interface between Financial Reporting and Regulatory Capital

Part 4 - Observations of IASB'S reaction to criticisms of FVA



Reactions of IASB

- Initial reaction of IASB – not to change any FVA rules
- IASB reconsidered its decisions due to the continued pressure
- IASB is working closely with the Financial Stability Forum (FSF)

Reactions of IASB con't

➤ The FSF has made a number of recommendations such as:

- (1) improve the accounting and disclosure standards and work with other standard-setters towards international convergence;
- (2) enhance its guidance on valuing financial instruments when markets are no longer active; and
- (3) strengthen its standards to achieve better disclosures.

Reactions of IASB Towards the Regulations

- In October 2008 - relaxed its position on FVA by allowing companies **to transfer non-derivative financial assets out of classifications that are reported at fair value into categories that use amortized cost to value assets.**
- on 13 October 2008, **the IASB took the unprecedented step of amending IAS 39** without first issuing the changes in the form of an exposure draft for public comment. This move was in direct response to pressure from the EU.
- October 31, 2008 - the IASB **published educational guidance** on fair value measurement of financial instruments in markets that are no longer active.

Reactions of IASB Towards the Regulations con't

- In May 2009, the IASB published an [exposure draft on Fair Value Measurement](#). The proposed guidance deals with how fair value should be measured where it is required by existing standards.

Sir David Tweedie, Chairman of the IASB, said:

“This exposure draft is an important milestone in our response to the global financial crisis. The proposed guidance proposes clear and consistent guidance for the measurement of fair value and also addresses valuation issues that arise in markets that have become inactive” (IASB, 2009).

Reactions of IASB Towards the Regulations con't

- **The outcome of the exposure draft on Fair Value Measurement is IFRS 13 which** is effective from 1 January 2013. (Early application is permitted).
- IFRS 13 provides clear and consistent guidance for measuring fair value and addressing valuation uncertainty in **markets that are no longer active**. It also increases the transparency of fair value measurements by requiring detailed disclosures about fair values **derived using models**.

Impact of IFRS 13 on Businesses

- The need to disclose a sensitivity analysis - **require the most management judgment.**
- The new draft contains certain disclosure requirements when an asset is used in a way that differs from its highest and best use.

Impact of IFRS 13 on Businesses con't

- Financial statement preparers have already commented that **it will entail significant effort and money to obtain this additional information.**
- It will affect a broad spectrum of entities, such as for-profits, nonprofits, pension plans and investment companies.
- Representatives from various industries are lobbying to have these standards not apply to them.

Fiji's Position on IFRS 13

- Fiji already has an exemption standard relating to the requirement in IAS 39 to report untraded equities at fair value.
- Fiji is **almost certain** to write an '**Exemption Standard**' to IFRS 13 that will absolve reporting entities from using fair values for unquoted investments and certain other financial assets.

Reactions of IASB con't

IFRS 9 - Financial Instruments (replacement of IAS 39)

- Criticisms of IAS 39
- IFRS 9 *Financial Instruments* was published in November 2009 and contained requirements for financial assets.
- On 4 August 2011, the Board issued an exposure draft proposing to change the mandatory effective date of IFRS 9 to 2015

Concluding Comments

- IASB has been taken to task for not being careful in providing enough guidance on the use of fair value rules.
- Pressures from the national bodies are inevitable.

Concluding Comments con't

In Fiji all entities outside the finance sector took the 'deemed cost' option allowed by IFRS1 for reporting when transitioning to IFRS, so reporting entities are bent on minimizing the impact that fair value will have on reporting.

Thank You