

VOX

The IFRS' stress test

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Some blame poor accounting standards for the crisis, and many now place accounting reform atop the global agenda. But the International Accounting Standards Board suffers significant institutional weaknesses, this column argues. While the International Financial Reporting Standards are not doomed to failure, there is significant risk of globally fragmented and divergent accounting standards, which would be a loss for everyone.

The International Accounting Standards Board (IASB), which decides the content of International Financial Reporting Standards (IFRS), had its eighth birthday in April (though its roots can be traced back to 1973). Few companies used IFRS before their 2005 application throughout the EU. The financial crisis is thus the first real test for this arguably unique experiment in global economic policymaking.

And what a test it is. Accounting standards are now on the agenda at the highest level. They are cited by some as being a cause of the crisis. The number-one suspect is “fair value”, the accounting method based on observable transaction prices or, if none are available, evaluation models. The IFRS make liberal use of fair value, as do the US GAAP standards applicable in America; similar controversies rage on both sides of the Atlantic. As early as March 2008, Martin Sullivan, then CEO of insurance giant AIG, championed the call for the “suspension” of fair value. While AIG has collapsed for other reasons in the meantime, this call is still echoed by much of the US banking industry and many European financiers, especially in France – even though the available facts-based studies, such as SEC (2008) or Coval et al. (2009), fail to support their case.

In October 2008, the EU forced the IASB to revise its asset classification rules with retroactive effect in order to permit banks to book fewer assets at fair value. In doing so, the IASB broke its consultation principles, and its chairman David Tweedie almost resigned at the moment of biting the bullet. Mary Schapiro, the new president of the SEC, later cited this lack of freedom from political interference as a reason for the US to delay IFRS adoption. In 2003-04, when faced with similar pressure over IAS standard 39 on financial instruments, Sir David and his colleagues had refused to budge. In yielding this time, the IASB has taken the risk of compromising its credibility.

That accounting standards are a political issue is no news. In 1993-94 the US Congress arm-twisted the Financial Accounting Standards Board (FASB), which issues US generally accepted accounting principles (GAAP), into watering down a much-needed standard on stock options. Today Congress, at the behest of the banking sector, is pushing to dampen the impact of fair value accounting methods, and in April the FASB gave some ground. How this about-face compares with the IASB's one six months earlier remains a matter of controversy. In any case, the SEC plays a key anchoring role in the US as guarantor of the FASB. The IASB has no such official public cover and stands alone in the storm, tossed by the contradictory demands of its many stakeholders.

The IASB suffers chiefly from the weaknesses of its institutional set-up. During the crucial years of EU adoption, it benefited from the dynamic duo of David Tweedie and Paul Volcker, then chairman of the Trustees and a highly respected personality in the financial community. But Volcker left in 2006. At age 81, he now advises Barack Obama on economic policy. His current replacement, Gerrit Zalm, spends limited time on IFRS matters. After years of denial, the 22 Trustees have realised that the rudimentary governance framework installed in 2001 is in need of reform. But the Monitoring Board, a small group of public authorities (including the SEC and the European Commission) to whom they conferred the power over Trustee appointments in January, is an ill thought-out device and a recipe for dysfunction (Véron, 2008). The European Commission, which had championed the IASB in 2002 but is now rather clumsily attempting to control it, has not yet signed the Monitoring Board's founding documents, even as Internal

Market Commissioner McCreevy participated in the opening session in April. The sense of confusion is palpable.

Meanwhile, the IASB is taking initiatives. The Financial Crisis Advisory Group it set up at the end of 2008 is doing useful work in bringing about a shared analysis of the crisis. The choice to comprehensively revise IAS 39 in coordination with the FASB, rather than making piecemeal amendments, is a sensible one. Also, two recognised members of the user community have just been appointed to the IASB. This represents genuine progress. But this may be too little, too late. Gerrit Zalm has been perceived as conflicted since he became head of ABN Amro, the nationalised Dutch bank. The other Trustees are mostly absent from public debate. David Tweedie, whose term expires in 2011, has made many enemies, and he can no longer exert the same leadership as before.

The IFRS are not yet doomed to failure, which would mean global fragmentation and divergence of accounting standards used in Europe, the US, and Asian countries. But this risk is becoming increasingly real. If this were to happen, Europe is most likely to find itself at a disadvantage compared with the US, as it was in the 1990s, as most investors would consider the US GAAP standards to be more demanding. Actually, everyone would lose out.

References

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