Can accounting standards be scapegoated for the turmoil?

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The financial crisis leaves no one untouched. Recently, International Financial Reporting Standards (IFRS) have been put in the dock by prominent French commentators.

The charge is that IFRS are based on a dogmatic notion of fair value, lead to financial statements that bear little relationship to economic reality, and encourage first speculation then panic on the markets.

Is accounting information to be fundamentally questioned again, as it was after the Enron and Worldcom scandals in 2002?

The tension between accounting standards and financial stability is not new. In times of crisis, banks are tempted to smooth the impact of bad news, and supervisory authorities see merits in limiting a negative newsflow that may drive markets to madness. By contrast, investors want complete information in order to react speedily, even if the consequences are dire.

When the IAS39 accounting standard on financial instruments was adopted, severe criticism was expressed by the Basel Committee, which prepares global prudential standards for the banking industry. More recently the US, via the Securities and Exchange Commission, authorised banks to deconsolidate securitisation products, when a strict reading of US standards may have required these to be taken back onto the balance sheet.

But stability and transparency do not weigh the same in the setting of IFRS, because the standards are designed primarily to meet the demands of investors, the main users of financial information. The primacy of investors is set out unambiguously in the IFRS framework and has been a key driver of their global success.

From this angle, subjecting standards to the imperative of stability might entail the risk of lower-quality financial information.

Indeed, the trade-off between transparency and stability is not at all clear. In the short term, the disclosure of banking difficulties may accelerate loss of confidence and exacerbate systemic risk. But in the mid term, transparency requirements strengthen the banks' internal discipline and risk management, and reassure the market.

IFRS have forced banks in France and elsewhere in Europe to publish much more information than before on their use of derivatives. Without this information, markets would probably be even more jumpy than they are today.

In November 2006, a report by the Banking Supervision Committee of the European Central Bank concluded that consistent and rigorous application of IFRS could increase the stability of the financial system, by virtue of this disciplining effect.

On the contrary, when banks enjoy a broad discretionary margin in accounting for their risks, delays in acknowledging losses can prove disastrous: witness the Japanese experience of the 1990s, or France's own Credit Lyonnais in 1992-93.

Pierre Cailleteau, chief international economist of Moody's, the rating agency, concludes in a recent note that the mark-to-market approach of IFRS is, as Churchill said of democracy, the worst system – except for all the others.

Contrary to the caricature painted by critics, IFRS are far from imposing full fair value accounting. Moreover, the requirement of transparency is qualified by a presentational device: fluctuations in the value of financial instruments deemed available for sale, which weigh heavily in the balance sheet of financial companies, have an impact on shareholders' equity, but not on earnings per share. This compromise is far from ideal but has the merit of being pragmatic.

Nuances are warranted also as regards consolidation. Some banks appear to have been imprudent in their use of off-balance-sheet vehicles such as conduits and SIVs, but it would be unreasonable to consolidate everything. The idea of introducing into IFRS a 'parallel balance-sheet' including all off-balance-sheet items is an interesting avenue to explore in the attempt to square this circle.

In the last few months, markets have suffered not so much from misleading accounting methods as from a deficit of disclosure, especially about complex securitisation products, on which credit rating has reached its limits. The data required is primarily probabilistic information, which is not well conveyed by accounting standards whose main goal remains to provide data on value within a limited margin of error.

The inadequacy of financial risk information is one of the major problems revealed by the current crisis. But accounting standards are neither the source of this problem, nor the remedy.

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(1) « Archaeology of the Crisis », January 2008, available on www.moodys.com.