Comments from PwC, submitted by John Hitchins

Q20: To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

Listed companies in the EU are required to prepare financial statements that show a true and fair view in accordance with International Financial Reporting Standards (IFRS). IFRS as a framework seeks to report economic performance as it happens – economic performance can be volatile and it is inappropriate to expect an accounting framework to be designed to be capable of smoothing this impact out. Attempts to do so in the past have always involved a loss of transparency through the use of mechanisms such as hidden reserves or general provisions for doubtful loans which can vary from year to year – these do not allow the transparent reporting of results and financial position.

There has been a debate over whether IFRS requirements for fair valuing financial instruments contributed to short-termism and whether this was a contributory factor in the financial crisis. Some argue that recording fair value movements in profit and loss before the crisis resulted in 'unrealised' profits being recorded and paid out in bonuses and dividends. Others argue that fair value write-downs during the crisis created excessive strain on balance sheets leading to distress sales and further write-downs, causing a 'pro-cyclical' spiral of downward pressure on prices and ever reducing liquidity in the marketplace. However, it is the case that fair value write-downs provided early warning signals that led to corrective actions sooner than otherwise would have been the case if such losses had not been recognised.

The valuation of assets immediately prior to the crisis was based on actual prices achieved in the market from real transactions. 'Real transactions in unreal markets' is how one analyst has described it. Without the benefit of hindsight, it is almost impossible to distinguish between a buoyant market and an 'unreal' one. Once in the crisis it was also clear there that were substantial falls in asset values which could not be ignored in preparing financial statements. However, in our work, we have not identified evidence to support the allegation of systemic overvaluation of assets prior to the crisis. There is no reliable mechanism for separating out 'true' loss from 'unreal' loss caused by the lack of liquidity in stressed market conditions.

A United Kingdom Parliamentary Committee inquiry examined the role of accounting in a report in 2009 on the Banking Crisis and noted that fair value accounting had resulted in greater transparency and exposed the over-inflation and subsequent correction of asset prices, and done so more quickly than other accounting measurement methods. It concluded *"we do not consider fair value accounting to be a suitable scapegoat for the hubris, poor risk controls and bad decisions of the banking sector."*

There has also been a debate over the best method of accounting for profits and losses in trading instruments and whether there are there any alternatives to 'mark-to-market' or 'mark-to-model' techniques. Trading assets are held for the short term and fair value accounting reflects the best estimate of the cash flows that are likely to be realised from them. It for this reason that national accounting standards in some European countries (eg the UK) moved to fair value from the lower of cost and net realisable value prior to the introduction of IFRS.

At any time when trading volumes decline significantly and trading assets cease to be liquid, it can be legitimate to argue that as the assets are no longer held for short term gain they should be reclassified to amortised cost. However, an arbitrary application of this approach has the effect of reducing transparency and could lead investors to question balance sheet values. We therefore support the International Accounting Standards Board's (IASB) development of a business model approach to the classification and measurement of financial instruments in IFRS 9 – *Classification and Measurement*, which requires financial assets to be carried at fair value where they are held with a view to realisation through day to day trading. Subsequent reclassification is required where the business model changes from one of day to day trading to one of holding for long term realisation of income and 'capital gain', with full disclosure of the rationale for, and the effect of, the change.

The use of fair value and different accounting measurement techniques have been carefully reviewed and retuned by the IASB since the crisis and some new or revised standards have been issued, such as IFRS 9 , though not all of these have yet been adopted for use in the EU.

Other issues:

Assets held for the long term but measured at fair value can create a mismatch where the matching liability or funding is measured on a different basis - for example pension assets and liabilities. IFRS generally seeks to address this by recording the fair value movements in 'Other Comprehensive Income' so that the core performance measurement - the profit and loss account - is not distorted. The measurement of assets and liabilities in the insurance sector is being addressed by the current IASB project on insurance.

Overall, however, we believe that IFRS remains the most appropriate model available for financial reporting. It is up to companies to use the annual report and other communications to put the accounting in context, as the Enhanced Disclosure Task Force has been advocating for financial institutions under the auspices of the Financial Stability Board. There is no intrinsic reason why IFRS should drive behaviour that is not in the best interest of companies or pension schemes."