Attention EFRAG

European Financial Reporting Advisory Group

On behalf of RVA Consulting (Sweden) and the Centre for Research in Finance and Accounting (CRiFA, University of Hertfordshire, UK) we would like to make the following observations, which we hope may inform the Financial Crisis Advisory Group through the auspices of the European Financial Reporting Advisory Group.

The main feature(s) of financial statements for users in capital markets are financial analysis and evaluation of investments. Financial comparability between firms, sectors and countries are important for investors in their judgement of entities financial risk-return profile and thus construction of portfolios. As such we would support the effort towards establishing one set of high-quality global financial reporting standards.

In our academic research into corporate performance and capital markets (Andersson: 2006 2007 and 2008) we have been concerned with the accounting standards setting project that installed "mark to market" accounting into corporate balance sheets, in the interests of shareholders and investors in capital markets. This drive to install mark to market accounting came from institutional shareholders and a desire to see the corporate sector re-made in the image of investment banks. The current banking crisis calls into question the viability of a banking business model founded on re-calibrating financials to mark to market. (Heilpern, 2009)

Our argument is that the process of "mark to market" accounting not only exacerbates cyclical transmission mechanisms, it also amplifies corporate restructuring activities because balance sheet adjustments are wired into both the up and downside of the business cycle. On the up-side market value absorption increase capitalisation rates in the balance sheet ahead of the generation of cash resources, increasing market value at risk and magnifying liquidity disconnect. On the downside, mark to market holding losses undermine corporate earnings and amplify restructuring. Restoring earnings capacity after registering these holding losses has serious implications for social welfare, employment levels and aggregate household demand because labour costs account for the majority of corporate sector value retained in the national economy.

The current financial crisis presents a challenge: how do we get back to a conservative process of accounting where accounting standards are tested for simplicity and clarity not technical complexity and ambiguity? We need accounting numbers to tell us something sensible about ***relative*** corporate performance and inform shareholders and other stakeholders how cash generated from operations (in addition to external financing) is growing historic cost balance sheets.

There are three general positions we would take:

A. Balance sheet transactions recorded at historic cost to avoid the volatility imparted by mark to market calibrations. Holding gains and losses (attributable to adjusting the market value of asset and liabilities) shown as a separate note for analysts and investors that wish to take into account capital market arbitrage and market value at risk.

B. Annual reports must disclose a full "nature of expense" format in addition to the traditional "function of expenses" approach. The nature of expense approach: limits variability associated with judgements about expense allocations to functions (such as R&D etc), aligns with national accounting frameworks and reveals how arbitrage between product, factor and capital markets is connected to corporate earnings capacity

C. Cash from operations is the fulcrum upon which corporate, renewal performance and valuation be judged. A direct rather indirect cash flow statement is a priority.

Note that point A relates to the "Financial Crisis Advisory Groups request for input", whereas points B-C relates to "Preliminary Views on Financial Statement Presentation".

It is not clear how, following the current financial crisis, the current agenda set out by the Financial Crisis Advisory Group will contribute towards encouraging stability and informing stakeholders about corporate performance and risk.

At a time where investors are increasingly risk averse and broader direct and indirect stakeholder groups are concerned about the viability and sustainability of the corporate sector and firms with which they are directly engaged. It is time to ensure that accounting:

- Makes visible factor market arbitrage and resource consumption embodied in the production of goods and services
- Reveals how financial resources are distributed to stakeholders,
- Promotes an orderly process of corporate restructuring via the capital market.
- Facilitates the aggregation of firm level data into industry sector and national accounts to as to better inform management of the economy.

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Appendix - Reference list:

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