

Current issues financial accounting

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The journal article named “ The crisis of fair-value accounting: Making sense of the recent debate” is written by Christian Laux and Christian Leuz in Accounting and Organisations and Society journal (2009). Mr Laux works as a professor of finance at the Goethe University in Frankfurt and his research has been published in many journals. Mr Leuz works as a professor of International Economics at University of Chicago Booth School of Business. He has done a lot of research and published his findings in several journals while acquiring many several grants and honours. Both authors have an immense amount of experience and qualifications in the area of accounting. The accounting topics that are covered in this article are financial instruments and recognition, relevance, reliability and measurement.

Objective of the article

The recent financial crisis has led to a vigorous debate about the pro and cons of fair value accounting (FVA), and this debate presents a major challenge for FVA going forward, Christian Laux and Christian Leuz has written ‘ The crisis of air value accounting: Making sense of the recent debate.” The authors have evaluated the critics’ arguments that FVA has considerably contributed to the financial crisis and intensified its severity for financial institutions around the world. Also proponent’s views that FVA merely played the role of the proverbial messenger.

This article’s objectives are to make sense of the current fair value debate and discuss whether many of the arguments in this debate hold up to further scrutiny.

The authors have achieved their objectives by explaining what FVA is and discussing the key arguments for and against FVA. It also considers what's new and what's different about FVA as the authors believes confusion about this adds to the debate and non use of FVA. They further discuss the pros and cons of historical cost accounting as an alternative to FVA and discuss potential implementation problems and speciality the banks' position on FVA. The authors have examined the concerns that FVA contributes to contagion and procyclicality. It analyses which accounting practices can help to alleviate these problems and discuss the relationship between FVA and accounting standards such as IFRS, US GAAP.

The authors give a thorough and logical view of both sides of the debate referencing other studies undertaken on this subject. They conclude the article with several suggestions for future research.

Research Design

The authors have gathered in-depth data and research from others sources to logically write this article. They have used an interpretive analysis aiming to give a better understanding for the readers. The article has been structurally put together in a clear and concise way to discover deeper meanings for the readers.

Main findings

The authors concludes that much of the controversy about FVA results from confusion about what is new and different about FVA as well as different views about the purpose of FVA. The authors also recognise trade off of FVA

in certain situations acknowledges that standard setters will always face these issues and tradeoffs and site the trade off between relevance and reliability which have been debated for decades.

The authors also finds that although there are legitimate concerns about marking assets values to market prices in times of financial crisis they conclude that these problem may not be best addressed with changes to the accounting system but more appropriately be addressed by adjusting contracts and regulation. And although the downward spiral is most pronounced for FVA in its pure form both US GAAP and IFRS allow for deviations from market prices under certain circumstances thus they conclude that the standards themselves may not be the source of the problem.

The article concludes that there could be implementation problems in practice as accounting rules interact with other elements of the institutional framework. Also there are multitude of rules stipulating how each item is treated in Balance Sheet and Profit and Loss Account and some treatments are contrasting leaving the accountants confused. There is more flexibility for manipulation of the accounting figures. The authors also points out that this flexibility for manipulation should not be underestimated citing past loans and goodwill policies crisis.

The article also finds after discussing the arguments for and against Historical Cost Accounting that is could not be a good replacement for FVA and HCA has problems more severe than the problems with FVA.

The article concludes that the debate about FVA is full of arguments that do not hold up to further scrutiny and need more economic analysis. The authors concludes that in their view, it is better to design prudential regulation that accepts FVA as a starting point but sets explicit counter cyclical capital requirements.

The article concludes that trade off between transparency and financial stability as well as the interactions between accounting and prudential regulations needs further analysis and suggest areas for further research which includes whether FVA did in fact contribute to the financial crisis through contagion effects, and the interactions between FVA and other important elements of the institutional framework.

The articles also suggests the study should be done to find out the what role HCA may have played for the banking crisis and the role of, off balance sheet vehicles and retained positions in asset securitizations in the crisis. And the role of the political forces in the standard setting process in the banking crisis.

Bodies of literature

The article was written as result of the recent financial crisis which has turned the spotlight on the Fair value Accounting (FVA) and led to a major policy debate involving among others the US Congress, the European Commission as well as banking and accounting regulators around the world. The American Bankers Association's letter to the SEC in September 2008, and the US Congress's pressure on FASB to change the accounting rules as

well as the articles by Forbes (2009) and Wallison (2008a, 2008b) and Whalen (2008) are cited to give credibility to the introduction of the articles.

The articles uses the works of Turner (2008) and Veron (2008) to state that the FVA is not the cause of the crisis and Ball (2008) who states that FVA provides important messages that should not be ignored to argue both sides of the debate that FVA caused the crisis.

The authors used FAS 157 definition of fair value as well as IFRS definition as well as IAS39 to give us a broadest possible meaning of fair value.

The articles has derived the pros and cons of FVA from different articles for example Barth (2004), Benston (2000) Penman (2007), and Ryan (2008) state that prices could be distorted by market inefficiencies, investor irrationality or liquidity problems: that fair values based on models are not reliable and that FVA contributes to the procyclicality for the financial system. This gives us the view of other scholars. When discussing HCA as an alternative to FVA the authors cites the studies done by Barberis & Thaler (2003) and Shleifer (2000) who argues that there are transactions costs and limits to arbitrage, and market prices may be subject to behavioural biases and investor irrationality. On the other hand they refer to the studies done by Kothari (2001) whether the market fully and correctly impounds financial information in price which makes FVA ineffective.

The authors have done thorough research not only of their subject but also to other literature which give credibility to their work and research. All these

literature also give strength to the authors' suggestion that this is a debate set to continue and that further research is necessary.

Implications of the study for accounting theory and practice

This article is another example that the accounting world does not agree to one set of accounting policies and both HCA and FVA have critics and supporters. Fair value is more relevant measure than HCA in many situations but it's not the perfect solution in some situations. Example the application of fair value accounting in illiquid markets and how and when modelling should be used as the method to determine fair value. FVA has exacerbated the financial crisis by creating large write-downs in financial institutions. Advantage of using HCA, is that allows banks to choose when to realize the gains and also impairment testing is less strict in HCA that give more flexibility for financial institutions.

Bank managers can accumulate the hidden reserves and choose the gains and losses tactically. On the other hand HCA give no indication to the current values of the assets in question and also does not show the loss of value as a result of inflation. Example; properties. This shows that there will be tradeoffs among the accounting policies and rather than simplifying the tradeoffs and complication, the FVA has aggravated the accounting practice. Standard setters will always grapple with the issues associated with accounting practice. This just goes to shows that accounting in the current situation is a complex process. The debate on FVA shows that any accounting system will not be accepted by all and may be used as a scape goat when another financial crisis occurs.