



# **Changes in accounting standards post the GFC – how effective will they be?**

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KPMG Partner**

# Overview

- Primary causes of the GFC
- Performance review of accounting framework during GFC
- Observations on effectiveness
- The IASB change agenda

# Primary causes of the GFC

- Sub-prime exposures in the US
- Overleveraging of the global economy
- Excessive risk taking & inadequate pricing of risk
- Inadequate capital in the banking sector
- Regulators, Credit rating agencies
- Accounting standards?

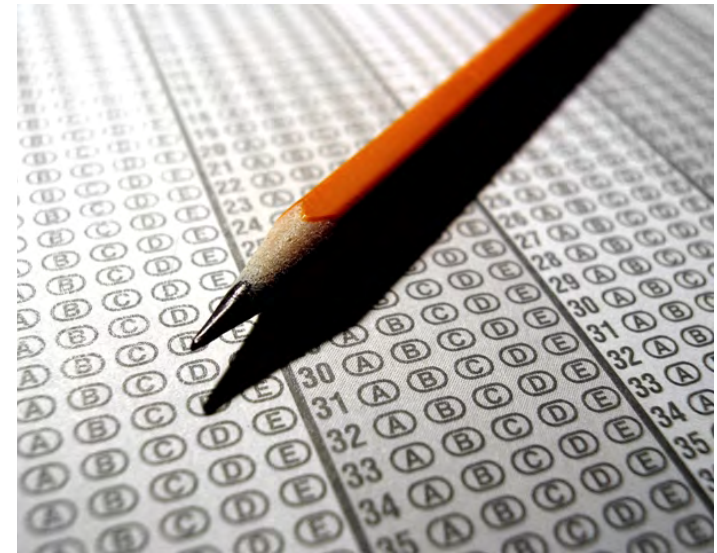


**Was accounting  
responsible for the GFC?**



# Performance of accounting framework during GFC

- Corporate collapses – role of the accounting framework
  - Fair value accounting – messenger or contributor?
  - Credit provisioning in financial institutions
  - Disclosures with respect to financial risks



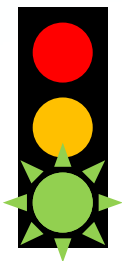
# Corporate collapses and bail outs



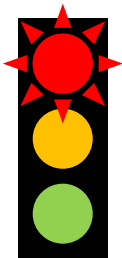
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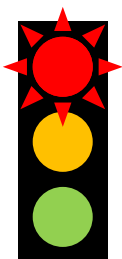
# Corporate collapses and bail outs



Highly leveraged



Uncertainty over financial asset carrying values



Liquidity issues

# Performance of accounting framework during GFC

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# Fair value accounting – what is it?

- Certain financial assets are measured at fair value, with changes in fair value recognised in P&L or equity

<b>Active markets (Level 1)</b>	Use quoted prices
<b>Observable inputs (Level 2)</b>	Use inputs that are <i>observable</i>
<b>Unobservable inputs (Level 3)</b>	Using inputs that are <i>not</i> based on <i>observable</i> market data

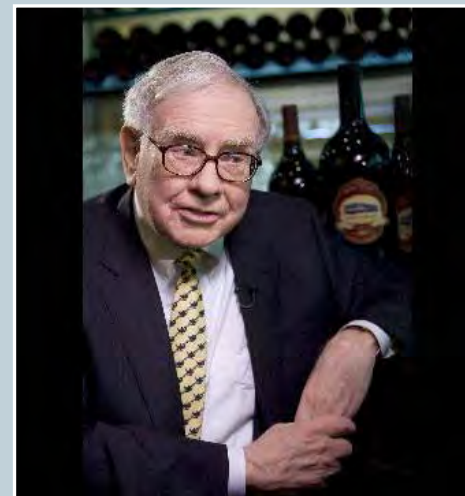
# Fair value accounting – what went wrong?

- Falling asset prices led to accounting losses
- Losses led to forced asset sales to meet regulatory requirements
- Forced sales exacerbated the fall in asset prices
- Liquidity in markets evaporated
- Inability to differentiate between distressed and willing transactions
- Fair value rules structured to avoid:
  - ability to hide losses
  - recognition of unrealised gains from models with no verifiable inputs

## Determining fair values

**“ Reference to an actual market transaction, even an imperfect one, is preferable in principle to an internal model elaborated by the issuer ”**

**“ In extreme cases, mark-to-model degenerates into what I would call mark-to-myth ”**



**Warren Buffet**

# Fair value accounting – messenger or contributor?

- Provides transparency – does P&L volatility reflect the reality
- Contributes to pro-cyclicality of the financial system
- Impairment of amortised cost based assets
- Practical application in illiquid markets
- If not fair value then what?

## Fair value accounting - the wash up

“

**At the end of the day, fair value accounting as currently prescribed in IFRS and US GAAP standards can be described in analogy with Churchill's portrayal of democracy, as the worst system with the exception of all others**

”

**Pierre Cailleateau,  
Moody's**

# Performance review of accounting framework during GFC

- Corporate collapses – role of the accounting framework
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- Credit provisioning in financial institutions
- Disclosures with respect to financial risks

# Credit provisioning in financial institutions

- “Incurred” loss model delayed the recognition of loan loss provisions
- Regulatory views on understated provisioning
  - Impact on profits & dividend levels
  - Ignored commercial reality that banks price products with expectation of credit losses

# Performance review of accounting framework during GFC

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# Disclosures with respect to financial risks

- IFRS 7 was introduced in August 2005 with amendments in 2007 and again in 2009
- Did investors properly understand the financial risks?
- Liquidity risk disclosures
- Off balance sheet disclosures
- Balance of commercial sensitivity vs. investor needs

A black and white goat with curved horns stands on a grassy hill next to a wooden post with a yellow sign that says "Observations". The goat is facing right and has a small red collar and a bell. The background is a misty, overcast sky.

**Observations**

**Observations on  
effectiveness  
of proposed  
changes**

# Observations on effectiveness of proposed changes

- Financial instruments – simplification....
  - Fair value accounting
  - Recognition & measurement
  - Reclassification from fair value to amortised cost
  - Fair value guidance
  - Credit provisioning
  - Disclosure
  - Hedge accounting

A large tower crane with a red lattice tower and a white and red jib is the central focus. The crane is positioned on a construction site, with its jib extending across the frame. In the foreground and to the right, there is a complex structure of yellow scaffolding and rebar, likely for a concrete slab. The background is a clear, bright blue sky. The overall scene is one of active construction.

# The IASB change agenda

# Drivers of changes in accounting

- Changes in business practices & failures following economic downturn
  - Enron – Financial instruments & Consolidation of SPEs
  - Dotcom boom - Share based payments
  - Pension deficits – Defined benefit plans
  - GFC – Financial instruments & Consolidation
- Convergence with US GAAP

# Significant changes proposed by the IASB

The Australian Financial Review  
www.afr.com • Wednesday 13 May 2009

## New rules to hit balance sheets

### In the pipeline

Key accounting changes on the way:

#### Leasing

Will force all operating leases on to balance sheets, increasing liabilities, in a major impact for all companies but particularly airlines. Submissions due June 12.



#### Revenue

Will defer revenue recognition, reducing profits with a big impact on property developers, infrastructure, telcos.

#### Acquisitions

Requires the transaction costs on acquisitions to be expensed from July 1, which will reduce the profits of many companies.

#### Superannuation

Will force the liability for superannuation contributions tax to be included, increasing deficits in many funds by 15 per cent.





#### Tax

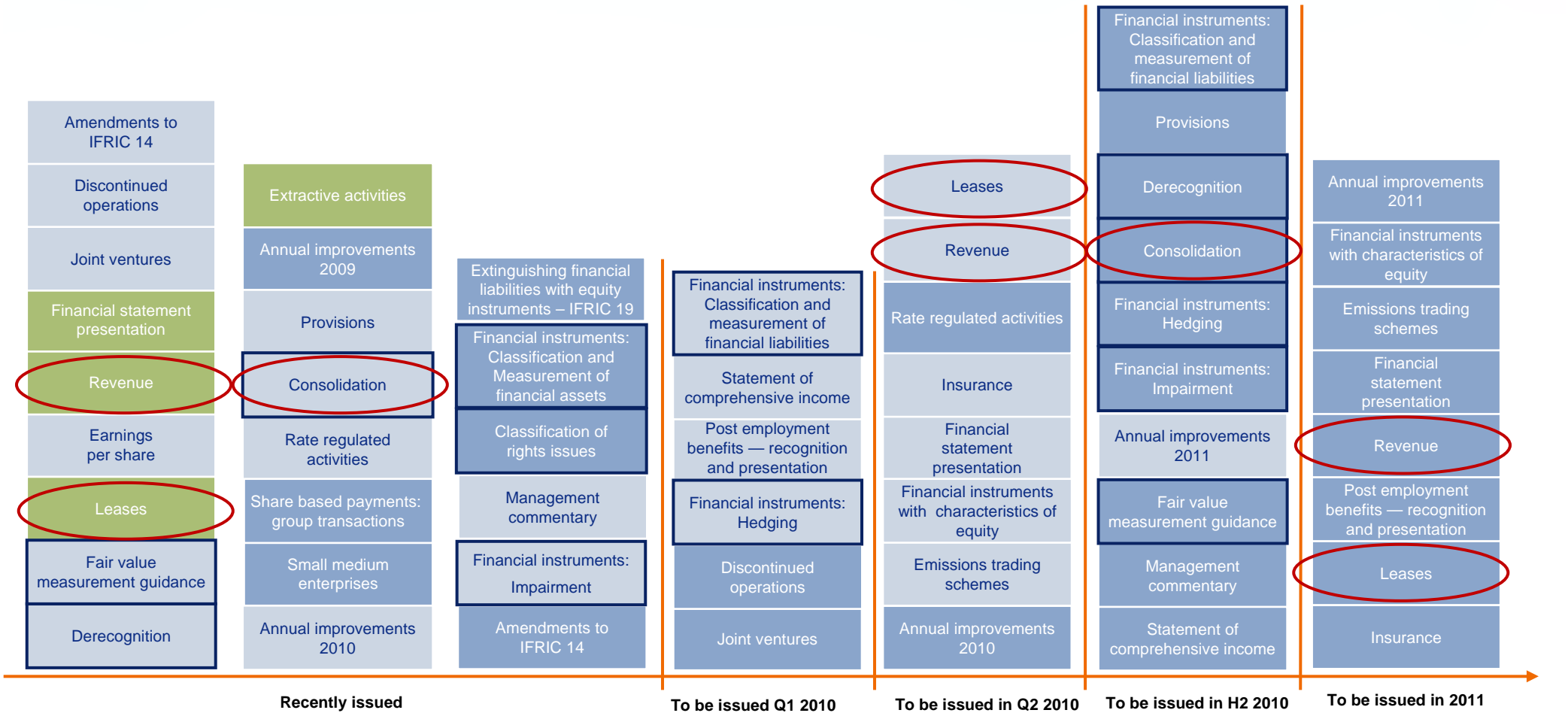
Proposals would bring deferred tax assets onto balance sheets.

#### Special purpose vehicles

Might have to be included on balance sheets, increasing liabilities.

# Next wave of IFRSs

Discussion Paper	
Exposure Draft	
Final Standard	
Projects in response to financial crisis	



# Observations on effectiveness of proposed changes

- Consolidation
- Revenue recognition
- Leasing
- Others – Tax, Liabilities

# The final word on effectiveness.....

- Limitations of financial reporting
- Principles based vs. Rules based standards
- Is it the accounting standards or their application?

# Questions



## Presenter's contact details

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# Acknowledgements

- Report of the Financial Crisis Advisory Group (July 2009)
- Michel Magnan, Fair value accounting and the financial crisis: Messenger or Contributor?
- Nicolas Veron, Fair value accounting is the wrong scapegoat for the crisis (May 2008)
- Robert Pozen, Harvard Business Review, Is it fair to blame fair value accounting for the financial crisis? (Nov 2009)
- Christian Laux, Christian Leuz, The crisis of fair value accounting: Making sense of the recent debate (April 2009)

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