BIS Accounting Workshop

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Comments on Mary Barth’s paper:

“Including Estimates of the Future in Today’s Financial Statements”

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Outline

Some aspects of the proposals in the Paper

Some perspectives

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Some aspects of the Paper

“Income is the difference between net assets recognised at the beginning of the period and net assets recognised at the end of the period.”

Fair value accounting creates the potential for either unintentional or intentional bias. Companies could significantly manage earnings with slight changes to valuation procedures. (FEI)

Fair value accounting P & L

Issue	Description	Debt Fair Value: Period End	Debt Fair Value: Period Start	Debt Fair Value: Change	Cashflows	Total Debt P&L	Swap Fair Value: Period End	Swap Fair Value: Period Start	Swap Fair Value: Change	Cashflows	Total Swap P&L	Total P&L
		(1,111.3)	(1,119.6)	8.3	0.0	8.3	77.9	89.2	(11.3)	0.0	(11.3)	(3.0)

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Credit spread P & L check

Issue	Description	CCY	Credit Spread P&L (USD m)	Credit Spread (Mid) Period End (bps)	Credit Spread (Mid) Period Start (bps)	Credit Spread (Mid) Change (bps)	Credit Spd PVBP At Period Start (USD m)	Implied P&L (USD m)	Difference (USD m)
		USD	0.7	14.20	11.68	2.53	0.4	1.0	(0.3)

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P & L disaggregation

Issue	Description	CCY	Actual P&L	P&L Explanation					Difference
				Credit Spread	FX/IR	Theta	Mid-Offer Spread	Total	
		USD	(3.0)	0.7	1.0	(3.8)	0.1	(2.0)	(1.0)

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Some aspects of the Paper (continued)

"Including more current estimates of the future likely enhances income's predictive ability."

The use of fair value clouds an investor's ability to evaluate management's performance, implying perfection in the scope and depth of markets and modelling techniques that don't exist. (FEI)

Some aspects of the Paper (continued)

Why does using fair values “improve financial reporting”?

In the absence of deep and liquid markets, and the open and transparent market information they provide, fair value is transferred from an objective into a subjective measure. (BBA)

Some key questions

What investor support is there on a global basis?

What cost/benefit analysis has been conducted given accounting systems are generally geared to historical cost?

Why would you use a model for financial reporting where “expected future sales” would be recognised as assets?

Example

A retailer buys shirts for $15 and sells them for $25.

There are 100 shirts in the shop at the balance sheet date.

Customers have bought shirts at $25 recently.

What value should the inventory be reported at:

- $15
- $25
- some other value?

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Example (continued)

The retailer has 15 other shops and has only sold 5 shirts.

He keeps the shirts on display for one month and then moves the stock to his other shops.

The shirts appear in a sale marked “20% off” at $20.

He does this on a regular basis.

Knowing this, would your answer be different?

Shareholders need a return on contributed capital not fair value capital.

Example on shareholder return

A shareholder invests $1000 in a company and $800 is “lost” in a fair value measurement process.

Profits of $50 are made.

Does the shareholder regard his return on capital as 5 per cent or 25 per cent?

Fair value as a measure

It is hard to argue that fair value is not a relevant measure.

However, other aspects of financial reporting are just as - and perhaps more - important: reliability, understandability and comparability. (FEI)

Example

A bank has a portfolio of retail loan assets of 1,000 earning LIBOR plus 5%.

The bank is funded on a matched basis at a cost of LIBOR.

What is the relevant measure?

Net Interest income (1000 x 5%)	50
Operating costs	(20)
	30
Loan impairment charges	(5)
	25

Why does overlaying the mark-to-market of the credit spread give a more relevant measure of profit?

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Relevance

Measuring all financial instruments at fair value neither produces information that better reflects the income generation process of the business nor does it provide investors with a better insight or understanding. (BBA)

Accounting would be based on the economic notion of opportunity cost, not contractual income and would therefore be divorced from the earnings and management process. (BBA)

Relevant information that is unreliable is useless to an investor. (FEI)

Closing Comments

If fair value is the [only] relevant measure, why does management not utilise it outside of the trading book?

Fair value reflects supply and demand at a point in time.

In the trading book, other measures such as projected net interest income and sensitivity are used.

Key assertions need to be tested

- the relevance of fair value
- investor demand.

Notional fair values neither pay dividends nor can be turned into cash.

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