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Market Value Accounting
in the
Financial Services Sector

by

W.P Hogan

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1. Preface

What has been witnessed over the past decade is a remarkable strategic shift in policies bearing upon the finance sector. The so-called deregulation of banking is just the most public manifestation of changes in the conditions under which market participants whether they be banks, insurance companies, stockbrokers and fund managers, conduct their day-to-day business. Various quantitative and qualitative restrictions, most often imposed directly by government, were abandoned in the first half of the 'eighties.

In place of these long-standing regulatory procedures, or direct controls as they were once called in distant days of simple language, banks and others must compete in all facets of market activity subject only to the concerns of supervisory authorities for system stability and related issues.[1] These systemic worries should not be treated lightly as events surrounding the stockmarket tumble on 19-20 October, 1987 were to amply show.

A major theme of this paper is on the significance of this strategic shift with deregulation of financial markets for the conduct and implementation of accounting policies. Under the regulatory provisions stemming from wartime arrangements and lasting through to the early 'eighties, accounting concepts and techniques had slim ties to wider issues in system behaviour. With market supervision the main feature of the activities pursued by monetary and financial authorities, the quality and extent of accounting information is as important to them as it is to users of the services offered by financial intermediaries through assets or liabilities activities.

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1 Connoisseurs of policy language may contrast the harsh description "regulatory" applied to the regime of quantitative and qualitative controls with the mellifluous "supervisory" description to authorities responsible for prudential matters.

2. Introduction

With this perspective the main features of this paper may be listed for guidance through its meanderings. Issues bearing upon the market valuation of assets and liabilities held by financial intermediaries, most of all banks, have been of increased interest during the past decade. The attractions of market value accounting were enhanced by two decades of relatively high inflation and the distortions of value arising with asset price speculation and its repercussions in the late 'sixties and through the 'seventies. In view of the severe questioning on the applicability of market valuations interests in and support for this approach in previous contributions must be acknowledged.(16) Much of the Australian impetus for a shift from historical values has come indirectly from the efforts of supervisory authorities in the securities industry to better inform markets with the goal of achieving more effective ones. Accounting information is just one feature. The quest for dissemination of accurate and prompt information embraces all facets of management activity. Such concerns have brought other changes as with revised legislation on insider trading.(17) In some instances the provision of information on market values is complementary to historical book values recorded in profit statements and balance sheet compilations, in others market valuations substitute for them.

This renewed surge of interest in, and then proposals on, market valuations for company balance sheets reflects widespread concern about the accounting values recorded in financial statements issued by companies leading to questions about the nature and quality of information by which to judge their worth. Equally important has been the significance of accounting information for assessing the stability of financial institutions which is tied to the effectiveness of prudential regulation by banking authorities. This linking has been fostered still further by the reporting responsibilities of any one bank's external auditors to the Reserve Bank of Australia(RBA).

Interest in issues arising with market values have been heightened by the exposure draft on financial instruments issued by the Australian Accounting Research Foundation in March 1993.(1) Proposals advanced in that draft bear upon valuations on both sides of the balance sheet of a bank

or similar intermediary whereas the existing accounting standards deal only with the revaluation of non-current assets.(2) It is tantamount to draft industry standard for the financial services sector, or at least for banks and other deposit-taking intermediaries.(21,p.3)

What market value accounting is about provides the topic for the next segment in this Lecture. This is followed by an analysis of markets and values to clarify some underpinnings to market value accounting. The latter part of the lecture raises some questions about applicability in the wider context of system stabilility across the financial services sector but especially in banking.

3. Market Values

Issues in market value accounting are not new. Much time was devoted to the theory and applications during the 'sixties and 'seventies. Within Australia the most prominent advocate has been Professor R.J. Chambers. His commentaries during those early appraisals of market value accounting did much to clarify thinking on theoretical matters while not ignoring applications.(7,8) All the advantages of hindsight some twenty years later lend support to his theoretical quest. Nor do his contributions deserve the criticism so often advanced about accounting debates on how accountants, ".. move from one unresolved issue to another, while the stock of unresolved issues continues to increase." (27,p.34)

The important concerns in the debates on this topic at that time were less about theoretical perceptions and much more about the applicability of concepts. While issues raised in critical appraisals were a reflection of the financial condition of non-financial companies, the concerns expressed then are relevant to contemporary discussion. When dealing with estimates of market value rather than prices taken directly from traded assets and liabilities, such as listed securities, confidence in the data could be secured only with support of, "... a dispersion measure.... and the average number of observations per item."(23, p.128) These worries about the means for implementing effectively the basic market value concepts have been prominent in recent debates about applicability to banking.(24) Of greater importance now than when aired with two decades ago, owing to the

proliferation of off-balance sheet activities, is the understanding of what constitutes liabilities. Confusions from times past are quite critical for understanding issues requiring resolution in any context in which market valuations may be deemed appropriate.(26)

(a) Exposure Draft 59: Financial Instruments

The concept of the financial instrument advanced in Exposure Draft 59 is broad embracing any contract that creates a financial asset in one entity and a financial liability or an equity claim in another. This means, for practical purposes, a wide range of familiar financial activities. Although past commentaries could not have envisaged the proliferation of financial instruments witnessed from about the time they were made the basic questions are about common matters.

What distinguishes the current proposals in Australia from similar propositions being advanced in the United States and other places is the intention to have market values, or their proxies, incorporated fully in the balance sheet statement and profit and loss account. By contrast, in the United States the proposals by accounting standards authorities on disclosures of fair value of financial instruments are for disclosure as notes to accounts. The importance of the Australian proposals lies in the efforts to be in the very forefront of accounting requirements. What advantage there is in such an approach, has not been explained, especially when much attention and lip service is paid to the provision of "level playing fields" such as with internationally agreed capital adequacy requirements for banks.

Elements specify the basis for judging whether or not a financial asset or financial liability shall be recognised.(1,p.27,para.28) The three recognition elements may be readily explained. First, in the case of an asset, it is probable that the service potential or future economic benefits embodied in the asset will eventuate. Secondly in the case of a liability, it is probable that the future sacrifice of service potential or future economic benefits will be required. The third feature which has received little attention, is whether or not the cost or other value of the asset to the entity or the amount of the liability can be measured reliably.

The third of these is the one to which most attention should be directed. Issues of reliability permeate any analysis of market valuation; this was the worry of Professor Ronald Ma nearly twenty years ago to which reference has been made.(23) No test or explanation of reliability is offered. This issue cannot be dismissed as the proposals for market valuation set aside statements of record based upon historical cost with estimates of expected outcomes combined with market prices and values all at a period end.

Assuming recognition is possible the proposal then allows financial assets and liabilities to be measured under two alternative approaches.[2] These are the net market value method or the purpose-led method. Most interest attaches to the substantial differences between the two.

The net market value method requires valuation of all financial assets and liabilities with net market value defined as the amount that would be exchanged on disposal of an asset or extinguishment of a liability in an orderly market after taking into account the expected transaction costs. Market value is to be determined by discounting future cash flows in all those cases where there is not an active market in the class of asset or liability. At each subsequent reporting date, the asset or liability is remeasured and recognised at its net market value. Gains or losses that arise when a financial asset or liability is remeasured are recognised in profit and loss immediately.

The purpose-led method values financial assets and financial liabilities differently depending on their classification into three categories described as investing or financing, hedging and trading. The three may be defined in the following ways:

i) Investing or financing where the company has the intent and ability to hold the instrument for the long term or until maturity. Each class of financial instrument classified as investing or financing may be accounted for at cost or net market value. By class is meant a group of financial assets or liabilities having a similar nature or function in the legal entity. However, for all classes of financial assets valued at

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2 What follows in the remainder of this section is a short appraisal of ED59. A longer commentary is available in a current journal.(19)

cost, the net market value of each financial asset must be compared with its carrying value at each reporting date. This is an overriding requirement. Any excess of carrying value over net market value must be recognised as an expense of the period. Financial assets must be considered individually in their class rather than on a portfolio basis. The value of liabilities recognised under the cost method does not change so that the lower of cost or net market value rule does not apply. Thus a gain cannot be recognised by writing down liabilities from their original face value to a lower net market value.

ii) Hedging arises when an entity has a specifically identified position and the effect of holding the instrument is to offset the exposure to risk. A hedge instrument is to be measured and recognised in the statement of financial position on the same basis as the position being hedged.

iii) Trading instruments are those financial assets and liabilities which do not fall within either of the above definitions. All financial assets and liabilities which are classified as trading are valued at net market value with any gains and losses being recognised in the profit and loss account. Interest revenue and expense is recognised as it accrues on trading instruments. Interest revenue and expense excludes any component due to a change in net market value.

Two features may be noted with investing and financing. The purpose-led method denies any adjustments to the value of liabilities when investing or financing. An explanation for this rigidity is not obvious. Worst still, there is no recognition that by denying adjustments to the value of liabilities, the proponents of Exposure Draft 59 put themselves in conflict with their net market value method. The comparable valuation method for assets is net realisable value which is the undiscounted recoverable amount. (14,p.2)

Provisions on accounting for hedging may be more stringent than at present.(25,p.3) Hedges are to be taken out only against enforceable contractual commitments to future transactions. However, recognition of any contract as a hedge seems only to apply to successful hedging; there has to be a high degree of correlation between the value of the hedge and the value of the item pledged.(1,p.63,para.143)

b) Some Queries

What are the implications of the proposal whereby writedowns of financial assets are to be recognised in the profit and loss account regardless of any expectation about recovery in the net market value being possible or likely in the future. This approach rejects any notion of a permanent diminution test prior to providing such writedowns. One aspect is what this means for the ways in which loan provisioning should be made in the future were the draft proposals to be implemented. With the market value method in which there is no allowance for lagging valuation responses to price changes, provisioning against future losses would not seem to be required. In similar fashion the general provision would serve no purpose because all valuations would be responding to contemporary pricing. However, an argument could offered for retaining a general provision based upon reliability arguments associated with the third recognition element to which I alluded earlier as being a worrying item. The general provision would then reflect estimates of dispersions around the mean values applied for balance sheet purposes. However, in all this paraphernalia of market value adjustments a note of caution must be entered about the impact of writedowns on market values of entities. A writedown is one of a series of possible actions to change the value of an entity.(27).

Reference has already been made to the bias in the proposals on the purpose-led method for market valuation. The denial of adjustment to financial liabilities under this approach sharpens concentration on the market value approach.(13,p.7) Expression of such a constrained preference ordering does not ensure acceptance of a method which portrays the financial assets and liabilities of an intermediary at the values such assets and liabilities could be bought or sold in the market place. This explicitly assumes that there are markets for all assets and liabilities. However, a significant proportion of a financial institution's assets are not really marketable. Market prices are generally not reflective of the price that would actually be bid were an entity's entire portfolio to be placed on the market. Typical trading volumes even in the most liquid securities markets do not usually absorb such large transactions. Moreover, many portfolios are hardly traded at all, most obviously with banks' loan portfolios, but more of that later.

Much remains to be clarified with respect to the implementation of net market valuation methods. Certainly the proposals in the exposure draft are supported by commentaries quite modest in their practical guidance. The concepts underlying discounted cash flows are very familiar. However, the bases for calculations reflect judgements and consideration of issues specific to each entity and instrument. The complexity of estimating procedures has been documented.(12) These features may be listed in the following ways:

i) Establishing the basis for classifying segments in a portfolio and linking each to procedures for estimating net market values;
ii) Explaining the methods for estimating expected cash flows with allowances for estimates of losses and late payment from credit risk and variability associated with early payments of loans and early withdrawal of deposits;
iii) Establishing the credit quality measures applying to all cash flows and discount rates;
iv) Determining the procedures for estimating the discount rate appropriate to each instrument or class of instrument; and,
v) Ensuring the bases for setting out the required documentation are clear.

While the issues with measuring net market values are the most prominent for any appraisal of the proposals in Exposure Draft 59 there seem to be any number of other ones. Issues in loan loss provisioning have already been mentioned. No less demanding are the narrow provisions for the setting-off of assets and liabilities. It will be much less than helpful should the propositions on this topic set back the very lengthy and hard-won negotiations under the auspices of Basle Committee on Banking Supervision, on netting agreements in financial markets.(4,5)

Market value accounting must bring more volatility in the value of total assets reported by banks and other intermediaries with the abandonment of the permanent diminution test for pricing assets. This should also flow on to the level of risk adjusted assets used in capital adequacy calculations. A bank's ability to control the level of this capital adequacy ratio may be impaired by the introduction of widespread use of market value accounting. Depending on the speed of adjustments to

statements of account a bank could be faced with an asymmetrical outcome. Rising net market values could bring conditions whereby additional capital will not be needed. In the opposite setting the bank may be in no position to raise more capital other than at very high rates of return so further enhancing its perceived riskiness.

The net market value method does compound another difficulty for understanding the role of intermediation. That method takes into account the expected transactions costs for disposal. This means that the financial intermediary is valued net at break-up values. There is no going-concern value in what is offered in the exposure draft. All costs of acquisition or disposal of the financial instruments are incorporated in the valuation. It is as if the financial intermediary is to be disposed of at the end of each accounting period and re-incarnated for the beginning of the next. The implications for borrowing and lending are challenging. It is as if all contractual financial arrangements were to be renewed every six months.

4. Markets and Values

The definition of net market value set forth in Exposure Draft 59 rests on what could be expected to be received from the disposal of an asset in an orderly market. A definition of an "orderly market" is not offered. The omission is mute witness to awkward efforts of others to express orderliness in terms of willing buyers and willing sellers. Willingness, as with volunteering, may be held by some to depend on the alternative choices on offer!

Fortunately, embarrassment is relieved by the guidance forthcoming from the Bank for International Settlements(BIS) which has been able to offer an understanding of a disorderly market in its latest annual report. (3,pp.172-179) Their approach is an argument by exclusion. For the BIS a disorderly market is a reflection of financial distress. As confidence in intermediaries evaporates, the disorderly withdrawal of funds, the drying-up of credit lines and the unwillingness to transact with troubled institutions force them to cut their lending drastically and to dispose of assets at "distress" prices. The typically high leverage of financial intermediaries, the close linkages between them and imperfect information about their underlying condition create a flammable mixture with the

potential for amplifying the crisis and its associated costs. Localised distress can easily spread through the system. Examples of these manifestations of distress have been witnessed from time to time in Australia during the past two decades, mostly in Victoria and South Australia.

Concern about systemic problems of this kind explain authorities' involvement in the management of financial distress. There are several ways of dealing with institutions in distress; forbearance, liquidation, and balance-sheet restructuring are means of maintaining the institutions in operation either as independent entities or merged with others.

Forbearance, best thought of as a "buying time" approach, reflecting a relaxation of supervisory and regulatory standards, has sometimes been adopted when the difficulties have been viewed as temporary. One example in some respects was the accommodating treatment of US money centre banks immediately after the onset of the crisis in lending to developing countries, especially as regards provisioning levels. Strong elements of forbearance can now be found in the Japanese authorities' handling of the current asset quality problems, as exemplified by the temporary relaxation of the accounting treatment of valuation losses. Although forbearance may work in certain circumstances, it is not without risk. Relaxation of supervisory discipline may weaken constraints on imprudent behaviour but in present circumstances problems have their origins in prior imprudence by the financial intermediaries implicated and possible previous laxity of supervising agencies.

Liquidation, or the piecemeal sale of the institutions' assets, is a comparatively infrequent procedure. This in part reflects the view that considerable value is lost when the assets of a bank are broken up, not least because of the disruption to established credit relationships. It is also due to concern about knock-on effects with the contagion spreading to other parts of banking and then the financial system more generally. Because the significance of these factors tends to grow with the size of the bank, it is typically the smaller institutions that are liquidated. It might be argued that markets can absorb only the relatively small portfolios of the lesser intermediaries!

The more common solution is to restructure the strained intermediaries' balance sheets. This invariably means a direct or indirect recapitalisation. Often this may be achieved in the new equities and private placements market as witnessed recently in Australia and the United Kingdom or through government participation as in the United States and the Scandinavian countries.

This spelling out of financial distress as an explanation of disorderly markets shows the difficulties with valuing at market those components of assets and liabilities of financial interemdiaries which are not traded directly in markets. A reasonable argument for the maintenance of the permanent diminution test when valuing balance sheet components would be that it attempts to offset the shorter term dislocations arising in markets from financial distress.

This loss of flexibility associated with the application of the net market value method in an orderly market brings out the extent to which much of what is proposed in the exposure draft is divorced from market practice. The orderly market assumption is far removed from the conditions associated with disorderly market reactions and distress all too familiar in recent years. What the orderly market assumption approximates is the concept of equilibrium in an efficient capital market.

5. Efficiency

In this context the concept of efficiency relates to the prices and values associated with all securities fully reflecting all available information. An efficient capital market is one in which prices are accurate signals for allocating financial capital to physical assets, such as buildings, plant and equipment. This means, in turn, that the returns or rewards on any one security offered in capital markets will reflect the general level in the market adjusted for the risk associated with that security. That return is best conceived as a normal return. This does not mean that actual returns do not vary around that normal level; only that any departures from it are random without persistent bias, positive or negative.

This spelling out of the connection between information and the pricing of securities defines the Efficient Capital Market Hypothesis

(ECMH). It defines the allocative efficiency of capital markets. Put at its strongest this proposition denies the possibility of an individual participant being able to earn consistently positive abnormal returns after taking into account transactions costs of trading. That interpretation rests upon all past and present information, public and private, being available to market participants. A less demanding version, the so-called "semi-strong form" of the hypothesis, refers to the efficiency of the market reacting to all such public information. With this interpretation there is scope for earning positive abnormal returns at least for some brief period during which private information is acted upon. The weakness in this version is that past information may be "lost" from memory as with participants in the recent property boom failing to recall the repercussions of the previous one in 1969-74.

The strong concept of efficiency rests upon firm assumptions. They are homogeneous expectations across all market participants and instant recognition and response to new information. The concept defines equilibrium because any shift from one equilibrium to another is instantaneous. The "semi-strong" concept allows for some time to adjust from one equilibrium to another as private information is disseminated in the public arena. In that process heterogeneous expectations of market participants adapt until homogenous expectations on market prices and values spell equilibrium.

The structure of the asset-pricing models underlying the explanations and connections between efficiency and equilibrium have been questioned in recent years.(15) For example, the Efficient Capital Market Hypothesis and the asset pricing models associated with it imply that management of financial asset should be passive. Hence high volumes of trading in equities and derivative markets associated with them are evidence against the prevalence of market efficiency.(22,p.1615)

However, the criticism does not reject the explanatory significance of these models for establishing conditions to secure equilibrium. But that set of conditions is specific to equilibrium and not helpful to any explanation of how equilibrium is achieved.

What casts still more doubt on the meanings of efficiency and equilibrium is the emerging evidence on speculative bubbles and self-reinforcing disturbance. Mostly, at least initially anyway, the workings of foreign exchange markets have shown the existence of speculative bubbles where the relative values of foreign currencies could be sustained for long periods far removed from perceived real purchasing power parity values.(18, Appendix) More recently work on securities prices has brought evidence suggesting that self-reinforcing departures from perceived equilibrium prices could be common. Fortunately, and by pleasing coincidence, much of this evidence has been brought together in a special survey offered in a very recent issue of The Economist.(29) Bubbles and self-reinforcing phenomena are likely to prove to be the same thing.

The purpose of this exploration of efficiency and equilibrium is to bring out the uncertainties associated with the theoretical underpinnings to market value accounting. With these queries established it is necessary to take up some specific aspects of market valuation and financial intermediation.

6. Intermediation

Were banks just managers of portfolios of marketable securities with no informational advantages about corporates they had funded there would be no conceptual or practical difficulties with market value applications. When a financial instrument was acquired, market value would be recorded as the net payment. With an asset or liability, this would be the historical cost or book value, adjusted for any fees being part of the purchase price. For off-balance sheet items, it would be the net prices paid or received. Market value would vary over the life of these instruments most of all from changes in the general levels of interest and foreign exchange rates bearing upon each contract though shifts in the credit standings of the parties would also contribute. Changes in market value could be determined from market prices of the tradeable instruments. This is the familiar experience with any securities trading activity.

Banks, however, specialize in assets that are not tradeable in markets, especially loans which constitute over 65 per cent of bank assets in Australia. The risks faced by banks and other financial intermediaries are

well documented in their complications, and implications for public policy.(10,11) One-quarter of bank assets are publicly traded or easy to mark to market. Banks also hold some portion of their portfolios in off-balance sheet commitments and guarantees not to be traded in markets. While major Australian banks differ in the extent of their off-balance sheet activities, a substantial proportion reflect commitments to instruments which are traded actively on exchanges and, in the case of currency options, in over-the-counter markets.

Banks have a special position whereby projects which could not be funded in the market because of insufficient information on project returns and borrower behaviour are financed through loans. Banks are able to do this because of cost advantages in information acquisition and monitoring. Bank management can secure information advantages over market participants and regulators on the quality of its individual loans. This is an issue in information asymmetry. This information advantage creates a problem for any bank's loans. The value of loans held by a bank, on average, will exceed the value that individual loans could command if sold because the act of offering any loan for sale may suggest that the private information is bad. Any cost advantage when monitoring a borrower means that the expected net return on a loan is higher if the loan is held by the bank. In the absence of a bank or other intermediary mitigating the information and monitoring problems, many bank borrowers could not issue debt at all, privately or in the new issues market.

These matters are separate from the situations of the larger privately-held company which chooses to avoid the scrutiny required of a public listed company. Such a company prefers the private monitoring by a bank, or a group of banks, of its debt.

The other feature which identifies the special position of banks is the capacity to lend at costs below those which would be incurred were the borrower to seek funds by issuing debt privately. Banks offer standard procedures for security against loans not requiring tailor-made agreements with each transaction.

When a bank instrument is not marketable, some sort of valuation model must be devised to derive an implicit market value. This implicit

value will differ according to any model's assumptions about information and access to direct financing by borrowers. The development of an appropriate valuation model would have to account for the private information and monitoring skills held by the bank. That this is complicated has been identified in the various analyses of the issues.(6)

If the problems with valuing a bank's assets reflect the complications arising with asymmetric information, then the position with liabilities is no less compelling and impressive. Central to any valuation of deposit liabilities of Australian banks is an assessment of the meaning of protection of bank depositors under the Banking Act. A former Governor of the Reserve Bank of Australia spelt out the extent of the commitment to protect depositors in the following words, "The Reserve Bank is the guardian, not the guarantor, of depositors' interests".(20,p.571) Were a bank to fail then deposit liabilities have priority over all other liabilities in claiming the assets of the bank. Hence the strength of support for deposit liabilities is impressive even if not expressed as explicit deposit insurance. Given this provision in the Banking Act then the appropriate valuation procedure should incorporate the risk-free rate of interest or something akin to it, being much different from market rates implicit in commentaries. Measurement provisions in the exposure draft do not seem to allow for such a possibility.(1,p.30,para.37)

This overlooked feature is but one of the problems confronting market valuation of deposit liabilities, especially of banks. The deposit liabilities of banks may be valued in a variety of ways be that in terms spelt out in the preceding paragraph or for comparable market instruments such as cash management trusts. However, any bank's obligations are in terms of the nominal or historical values recorded in its books; those values are the ones which must be met. Hence adjustments to the values of liabilities to allow for market valuations would be deceptive. The deception by changing the values of liabilities directly would be in failing to disclose actual commitments. The deception by a contra-asset adjustment would be in failing to reveal capacity to repay.

The methods advanced in the proposals contained within Exposure Draft 59 do not admit the complications treated in preceding paragraphs. Measurement difficulties may have been noted but barely so while some

conceptual difficulties have gone unrecognised.

7. System Stability

The listing of the three approaches offered by the BIS to rehabilitation or reconstruction of banks serves to illustrate relationships between market value accounting and forbearance. If forbearance is to be a measure open to the monetary authorities then a fully prescriptive requirement in terms of market value accounting cannot be imposed. One should note how forbearance is deemed to rest upon judgement about strains being temporary. Such a possibility would not be acceptable to the proponents of Exposure Draft 59 because they reject the permanent diminution test for changing asset values.(30,p.142)

Propositions on market valuation test the capacity of supervisory authorities to maintain system stability. The forbearance issues spelt out in the latest annual report of the BIS are not confined to the short term even if the discussion has been conveyed in terms of temporary strain. Property portfolios cannot be adapted to changed conditions by orderly means in a brief span. Adaptation will take years, probably in the Australian case for much of this decade if the experiences of adjustment to the 1969-74 property boom are a reasonable guide.

The ultimate responsibilities for system stability rest with the supervisory authorities of which the most important is the Reserve Bank of Australia with its authority for the pricing and supply of money and credit, and next the Insurance and Superannuation Commission with responsibility for the prudent management of those insurance and pension funds dominating funds management in Australia.

Those responsibilities are exercised in a complicated environment in which financial reporting and accounting has an essential role, a vital one. The basis for accounting cannot be taken in isolation. Confidence in the quality of performance is essential to the stability of the financial services sector. The purpose of the finance sector is to serve real activity, most obviously employment, output and investment. Hence rigidity in accounting requirements serves no good purpose should a financial stipulation induce real disturbance.

8. Appraisal

Proposals for placing market valuations through the balance sheets of banks and other financial intermediaries have a number of difficulties. Some of them relate to the methods proposed and coverage of particular items such as with hedging. Beyond this important technical focus are queries about the connections between financial intermediaries and market valuation with its surrogates based upon discounted cash flows. In essence the market valuation approach to the accounts of financial intermediaries treats those intermediaries as if they were agents.

Market valuation proposals offered in Exposure Draft 59 have not been argued effectively and explained sufficiently to secure their implementation. The means for securing efficient surrogates for market valuation of those financial instruments not actively traded are treated lightly. Valuation models for assets or liabilities are not explicit on the ramifications of forecasts of future prices and values. The theoretical underpinnings to the proposal are less convincing now than they were a decade ago.

The importance of the topic is to be found in its impact on the future requirements for directors and management of banks and other financial intermediaries, and their auditors. Their responsibilities would extend to explaining choices of values and prices across the expanding gamut of financial instruments. Cogent reasons for all decisions on balance sheet valuations would be required. Past flexibility arising with the permanent diminution test having been lost, the volatility of valuations of assets and liabilities would rise. The results could be misleading of real commitments to depositors. The onus for explanation of decisions on valuations would be more severe than at present.

The accounting profession generally, but most of all those working as auditors and advisers to banks, other financial intermediaries, fund managers and agents, cannot be isolated from the complicated structures and connections found in the financial services sector. Symbolic of those growing complications is the reporting task of banks' auditors with the RBA sullying the elysian relationship of auditor as agent and monitor for the shareholder as proprietor.

Looming over all these considerations is the system stability issue. Whether or not the monetary authorities should have the final sanction on what is reported publicly depends on what is achieved by public dissemination of information. Should that engender confidence in the financial system and its participating institutions then benefits are positive. However, recent experiences do not support that view. Incipient contagion with runs on intermediaries of various types has been common. Thus there are ample reasons for separating the accounting standards applicable to banks and other financial intermediaries from general reporting standards under corporations law. Should this not be done then, in times of substantial disturbance, the supervisory authorities could be expected to offer general guidance on valuation methods and procedures to be incorporated in accounts.

MKVAFSWP.

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