Remarks on the Incorporation of IFRS 9 "Financial Instruments" into EU Law

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The IFRS 9 "Financial Instruments" is a very complex matter, made yet more complicated by the experts responsible. This is something that politics will have to deal with. Even a former IASB Chairman admitted that he did not understand the previous regulation, the IAS 39.[1] This is, indeed, quite understandable. Unfortunately, the IFRS 9 does not seem to look much better. Against this background, I will try to present you all the arguments relating to this difficult situation in a clear and pointed manner. Due to the strict time limit, I will keep to the distributed manuscript in an abbreviated version.

Superficially, this might look like a rather dull accounting problem**. However, as the IFRS 9 is a standard in the financial industry, it is of great importance for the stability of the financial system. Not least on account of the fact that the IFRS result exerts an influence on the risk behaviour of investors and managers.**

Accounting research as the basis for underpinning political decisions

The incorporation of the IFRS 9 into EU Law is a political decision. Rational political decisions, as a rule, take scientific findings into consideration. The IFRS 9 deals with findings relating to the institutional problem-solving potential. At this point, there are certain questions to be asked: **Does the IFRS 9 contribute to the stability of the financial system rather more than its predecessor IAS 39 did? Does it create fewer incentives for risk-taking? Does it appear less pro-cyclical? Can it be implemented? Does the IFRS 9 meet the endorsement criteria of the IAS Regulation?** The answer to these questions is related to scientific "Why questions" and therefore also takes accounting research and standard setting processes into consideration.

As a rule, modern positivistic accounting research only delivers studies on the so-called value relevance of fair value accounting. **The fair value can be a real (mark-to-market) or model-platonic constructed market price (mark-to-model).** Value relevance of an accounting method exists if, for example, the accounting information (A) is closely related to the market information (P). But a correlation is not causality. Is A influencing P, or is P influencing A? Or are A and P the effects of a common cause? Furthermore, the implications of value relevance, as a standard of apparently good accounting, are trivial: The more market information (P) is included in accounting information, the higher is the statistic connection between A and P.[2] Using this method, **the stock market price has to be recognized in the balance sheet**. Thus, research can "verify" and give its blessings to the value relevance of this accounting method in terms of **a perfect correlation between the accounting information and the stock market price**. However, it remains unclear why value relevance should be

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[1] David Tweedie, Simplifying Global Accounting, Journal of Accountancy, July 2007 (http://www.journalofaccountancy.com/Issues/2007/Jul/SimplifyingGlobalAccountingSirDavidTweedieInterview.htm).

[2] Shyam Sunder, IFRS monopoly: the Pied Piper of financial reporting, Accounting and Business Research 2011, S. 297 ff.

a quality criterion of accounting, or indeed why politics should be guided by it. **Useful accounting is "for the markets" and not, like fair value valuation, "from the markets"[3] since accounting "from the markets" is at best useless, and at worst pro-cyclic and destabilizing. In any event, the logical consequence of finding a decision with regard to value relevance is the expansion of mark-to-market.[4] IAS 39 as well as the IFRS 9 both took this path.**

Looking at the reasons stated, it is inadvisable to accept political conclusions based on studies of value relevance. Moreover, other attempts at a statistic evaluation of accounting often suffer from a methodological problem: the focus on verification instead of falsifying hypotheses. If we observe several white swans individually in order to prove that all swans are (probably) white this would not be logically tenable. Rather, a high probability generates the antithesis to the content of a hypothesis.[5] Here again theoretical thinking cannot be replaced by "significance". Incidentally, a theoretical evaluation need not, of necessity, be stigmatized as normative. It can also be formulated in an objective-technological way.[6] This concerns the scientific attempt to "analyze institutional alternatives and social orders, and to assess them on the basis of their performance characteristics."[7] This quote contains an alternative comparison of institutions (ideas of problem solving) in terms of **usefulness, feasibility, and potential consequences**.[8] The main goal is to obtain objective and scientific insights which can guide the normative political decision to integrate the IFRS 9 into EU law.

Legislation through the IASB

Within the EU the legislator delegated the accounting standards for capital markets to a private committee of experts – the IASB. As a consequence of this, accounting standards were not only internationalized (which may sound good) but also monopolized and centralized.[9] This kind of accounting standard setting has, therefore, little to do with a market solution (or even a "market equilibrium "[10]). Rather, it is more a result of the power of the interest groups, as experts decide on a centralized basis. Therefore, there is no real competition of institutional problem-solving proposals. Their goal of synchronizing fair value accounting on a global basis rests on the G-20 decision in 2008 (Washington): „*The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard*". However, the *true* intention of the G-20, namely the creation of stability-oriented accounting and the desire to fight against procyclicality, is forgotten. **A destabilized way of accounting does not turn into a stabilized one by being applied worldwide. On the contrary, it becomes a systematic risk for the financial system.[11] Convergence harms more than it benefits.**

3 Shyam Sunder, IFRS monopoly: the Pied Piper of financial reporting, Accounting and Business Research 2011, S. 298.

4 Andreas Haaker, IFRS – Irrtümer, Widersprüche und unerwünschte Konsequenzen, Herne 2014, S. 174.

5 Karl R. Popper, Karl Popper Lesebuch, 2. Aufl., Tübingen 2010, S. 257.

6 Hans Albert, Kritik der reinen Erkenntnislehre, Tübingen 1986, S. 160-165.

7 Hans Albert, James M. Buchanan zum Gedächtnis, ORDO 2014, S. 9.

8 Andreas Haaker, IFRS – Irrtümer, Widersprüche und unerwünschte Konsequenzen, Herne 2014, S. 10.

9 Shyam Sunder, The Problem of Improving Financial Reporting, Izmir Review of Social Sciences 2013, S. 1-6.

10 Jannis Bischof/Holger Daske, IFRS Endorsement Criteria in Relation to IFRS 9, Study for the ECON Committee, Brussels 2015, S. 44.

11 Ulf Jessen/Andreas Haaker, Prudential Filters für unrealisierte Fair-Value-Gewinne? – Erwiderung zum Beitrag von Elke König, Betriebswirtschaftliche Forschung und Praxis 2013, S. 685 f.

On account of the influence of the EU guideline, national accounting systems - which (to a limited extent) are spontaneous systems in the Hayekian sense, as well as proven business problem-solving concepts such as cost accounting and the principal of realization (waiting to realize a profit until market transactions have confirmed it) - have been suppressed in favour of fair value. A creationist expert ideology has, as it were, supplanted the evolutionary trial-and-error process in accounting, not only in setting standards, but also in accounting practice. The IASB implements its fair value concept by using a salami tactic instead of Popper's piecemeal engineering (trial-and-error method).[12] Thereby, unexpected and undesired consequences can occur with each regulation – reinforced through conflicts of interest. **Democratic control is hardly capable of settling these conflicts of interest. Instead, the EU endorsement process effectively leads to a “sink or swim” decision: "take the standard package in its entirety, or leave it and live with the consequences". In the long term this cannot be of benefit to the institutional provisions of the EU regulatory agency which are intended to stabilize the financial system. The pro-cyclic role of "fair value", in accordance with IAS 39, appears to have confirmed this "prediction in principle" (= damage to financial stability) during the recent financial crisis.** This could well be the same for IFRS 9.

Fair value vs. prudence – a dichotomy

Profit and risk are connected. Most risks cannot be calculated (tail risk). If the management and investors only take the profit, and not the risk, into consideration, this leads to false incentives und overvaluations (asset price bubbles).[13] The principal of prudence protects against these over-valuations.[14] According to this, the acquisition costs of a financial instrument are to be booked as neutral, and kept as such, until a market realisation (sale) confirms a profit, or a loss is foreseeable. The IASB, as well as several dominant stakeholders, follow the “modern” financial theory. Here, risk is defined as volatility not as risk of loss. Within the IFRS the principal of prudence has been suppressed in favour of the “neutrality” of information. Thus, the way has been paved for market-oriented valuation (current value), which now bears the newspeak label of “fair” value[15] Anyone who argues against such linguistically asserted attributes like “fair” or “just” has already lost, even if they have better arguments. What, however, is fair about a non-objectified cash flow forecast with which the management can, in their own interest, calculate a “fair” value which exceeds the acquisition costs and leads to fictitious profit on the basis of which dividends and bonuses are justified? Such values cannot be reliably determined against the background of existing incentive structures. It turns out to be a fallacy that financial instruments are accompanied by reliably legible market prices (OTC) which can easily be recognised as fair value on the balance sheets. Yet, even if it were possible: **mark-to-market accounting presupposes market liquidity, which can all so easily be lost in a financial crisis**. Thus, no transparency can be provided: *„After all, you only find out who is swimming naked when the tide goes out.*“[16]

[12] Andreas Haaker, IFRS – Irrtümer, Widersprüche und unerwünschte Konsequenzen, Herne 2014, S. 269.
[13] Raghuram G. Rajan, Has Finance Made the World Riskier?, European Financial Management 2006, S. 501.
[14] Shyam Sunder, Accounting Antecedents of the Financial Crisis, in: Prudence vs. Liquidity: Alternative Approaches to Money, Finance and Accounting, Milan 2013, S. 35.
[15] Shyam Sunder, Accounting Antecedents of the Financial Crisis, in: Prudence vs. Liquidity: Alternative Approaches to Money, Finance and Accounting, Milan 2013, S. 35 f.
[16] Warren Buffett, Letter to Berkshire Shareholders 2001, S. 10.

The commercial principal of prudence as a guideline

It is regrettable that the principle of prudence has been removed from the framework as it used to assist the IASB as a guideline for setting standards. Although the principle of prudence can indeed be interpreted in different ways (also as a neutral evaluation), faced with the institutional precept of regulative commercial prudence, the IASB would be compelled to provide justification should incautious standards be used. This demands discipline.

In EU law the commercial principle of prudence would be a perfect candidate for the integration criteria contained in article 2 paragraphs 3 of the IAS regulation. **Certainly the principle of prudence could be subsumed under the EU's take over request in order to fulfill the true and fair view principle since this is to be interpreted within the meaning of the EU Accounting Directive, and the Directive's accounting principles are geared towards the principles of prudence, realization and acquisition costs.** Apart from the concept of accountability purpose, these principles also express the idea of **capital protection** which, in practice, is also of importance for the EU-IFRS as the expectation and promise of dividends are adjusted to the IFRS consolidated net profit. On the other hand, according to this interpretation the impairment only approach for goodwill should certainly not have been integrated into EU law at all.[17] Admittedly, not everyone shares this opinion, as "fair value" is deemed to be of use in making decisions, although one can find oneself going round in circles when it comes to its interpretation. Without the use of a theoretical concept the true and fair view remains either an empty formula or it ends in circular reasoning.

Due to its lack of reliability, model-based fair value accounting cannot be considered useful for making decisions. Furthermore, the equity value cannot be defined by using a fair value assessment. The relevant decision value (V) of investment decisions needs to be compared with the market prices of the company (P). (V>P – buy!, V<P – sell!). The internally generated goodwill is lacking. Value investors with a long term perspective have no use for fair value as an evaluation principle: „*When calculating value to challenge price, beware of using price in the calculation*“.[18]The value is calculated on the basis of the balance of accounts and GuV. As Prof. Penman states: ***“Fair values bring price bubbles into financial statements.”***[19]

IFRS 9 as a fair value standard

The IFRS 9 replaces the IAS 39 which even the former IASB Chairman, Sir David Tweedie, had not understood.[20] **During the financial crisis there was heavy criticism of the IAS 39. Complexity reduction and financial stability was intended to have been the main focus of the IRFS 9. Neither the one nor the other has been achieved.** Even the standard IFRS 9 contains around 235 pages with

[17] Joachim Hennrichs, Zur normativen Reichweite der IFRS, Neue Zeitschrift für Gesellschaftsrecht 2005, S. 785.
[18] Stephen H. Penman, Accounting for Value, New York 2011, S. 15.
[19] Stephen H. Penman, Financial reporting quality: is fair value a plus or a minus? Accounting and Business Research (Special Issue) 2007 S. 40.
[20] “I often say about IAS 39 [...] that, if you understand it, you haven’t read it properly – it’s incomprehensible.” (David Tweedie, Simplifying Global Accounting, Journal of Accountancy, July 2007 (http://www.journalofaccountancy.com/Issues/2007/Jul/SimplifyingGlobalAccountingSirDavidTweedieInterview.htm).

numerous detailed regulations. According to Prof. Barchow, it contains 20 pages more than the previous regulation.[21] **The IASB promised an improvement, and yet not much has changed.[22]**

Having regard to the question of stability orientation, it must be said that the **IFRS 9 still takes the fair value too much into account**.[23] An acquisition cost evaluation of financial instruments is only possible if the business model concerned is adjusted to the appropriation of the contractual cash flow, and its timeline is stipulated by contract. This primarily concerns loans and receivables. **Other financial instruments are evaluated at the fair value in accordance with IFRS 9** (through profit or loss or through other comprehensive income – OCI). This even applies to **non-marketable equity instruments**, which leads to a great deal of work and opens up scope for manipulation.

The financial lobby rightly criticizes the complexity, but not the **problematic fair value orientation which tempts us towards a risky and pro-cyclical business policy**. Business and values are driven by unrealistic valuation gains which further lead to a higher depreciation in value. **Come the time of the next financial crisis, at the very latest, those affected will once again be crying out for a suspension of fair value evaluation in favour of an acquisition cost evaluation.** This historical lesson from the financial crisis, despite disincentives and the potential for manipulation, seems audacious as an argument against the evaluation of acquisition costs and the retention of “fair value” within the IFRS 9.[24] Rather, it exposed the so-called "fair value" criterion as fair weather accounting, unable to weather a crisis.

Problems occurring during the period of application due to insufficient assertiveness are not only the fault of the enforcement institutions: „*Dealing with preparers’ incentives, and the challenge of verifying compliance with the standards they write, are integral parts of the standard setters’ job. They are not someone else’s problem. The prevalence of an attitude that ‘we write the standards and we leave it to others (mostly auditors) to enforce the standards’ makes financial reporting easy prey for financial engineering. While standard setters cannot eliminate preparers’ incentives to engage in financial engineering, they may render the standards more resistant to such distortions.*“[25]

Historical amnesia vis-à-vis fair value balance accounting

Although history does not repeat itself, it does tend to rhyme**. In 19th century Germany, the “modern” fair value was called ”current value” (Zeitwert).** In 1884 the justification of the law relating to the reformation of the Private Limited Company Act (Aktiennovelle) **sounds like a fair value criticism from the latest financial crises of 2008/2009**.[26] The draft law talks about the bleak picture of all the emerging stock companies and their irresistible breakdown which leads to a decrease in the whole prosperity of the people. The former legislator states that at the point **where**

21 Andreas Barckow, IFRS 9: Zieleinlauf bei der Bilanzierung von Finanzinstrumenten, DRSC-Quartalsbericht Q3/2014, S. 4.

22 Andreas Barckow, Wohin steuert die Rechnungslegung? – Einsichten und Auswirkungen auf die künftige Tätigkeit des DRSC, Die Wirtschaftsprüfung 2015, S. 459.

23 Andreas Haaker, Nummer 9 lebt! – Auswirkungen des finalen IFRS 9 auf die Bilanzierung von Finanzinstrumenten, Der Betrieb 2014, S. 2791.

24 Jannis Bischof/Holger Daske, IFRS Endorsement Criteria in Relation to IFRS 9, Study for the ECON Committee, Brussels 2015, S. 21.

25 Ronald A. Dye/Jonathan Glover/Shyam Sunder, Financial Engineering and the Arms Race Between Accounting Standard Setters and Preparers, Accounting Horizons 2015, S. 293.

26 Andreas Haaker/Patrick Velte, Zur Geschichte der Zeitwertbilanzierung in Deutschland, Zeitschrift für Unternehmensgeschichte [Journal of Business History] 2013, S. 73-104.

acquisitiveness and credulity meet a balance list based on the strictest principles is needed in order to prevent "imaginary" profit. The end result was the introduction of the principle of acquisition costs and thus the prohibition of valuating stock companies at current value (Zeitwert). Other companies implemented the same commercial principles. At this time the legislator seemed to be cleverer in banning the current value approach. In this respect, the financial industry seems to have learned a little, and now uses **the newspeak term "fair value"** for its lobbying work.

Non-endorsement

A non-endorsement of IFRS 9 in EU Law does not seem to be politically feasible given the long project duration. Companies need to have confidence in the application of law. In order to signal a stable-oriented EU accounting regulation vis-a-vis the IASB, the duty to provide **fair value valuation of (nonmarketable) equity instruments (e.g. GmbH shares) could be excluded from being incorporated.** The annual valuation of non-traded company shares is not practicable for companies outside the financial sector, and not useful due to discretionary powers. It is totally dispensable.

New impairment model

The expected loss approach of the IFRS 9 is an improvement on the incurred loss approach of the IAS 39. Expected defaults are to some extent accounted for on the balance sheet date. However, the IFRS regulations have been made unnecessarily complicated.
Taking the default quality into account, a differentiated 3 level model is provided for:

- on the **first level of credit risk provision there needs to be a 12 month expected loss**,
- on the **second level a lifetime expected loss is recorded after a significant increase of default probability** under further appropriation of the effective interest rate based on the gross book value,
- on the **third level a lifetime expected loss** is booked after determining an **"objective" indication of impairment** under further appropriation of the effective interest rate based on net book value.

IAS 39 only provided for the third level according to which depreciation is only to be recorded once a credit event has occurred.

Any reference to the stricter US-GAAP is not convincing, despite the fact that it already takes the lifetime expected loss, instead of the 12 month expected loss on the first level, into consideration. However, the maturity time/fixed interest rate time limits in the USA are so short that the actual effect appears to be quite small. For long term credit claims the step between the first level and the second or third is relevant.

Supplementation to value depreciation regulations through EU law

Looking at the IFRS 9 the step from the first (12 month expected loss) to the second (lifetime expected loss) seems to be problematic, as not only is a significant increase in the probability of default important but also the dependability of debt service cover on the balance sheet date. One has to take the lifetime expected loss into account since a "very good" can turn into a "good" through a significant degradation in credit quality. In cases of non-significant degradation, where a "sufficient" turns into an "insufficient", there is no absolute need to do this as long as no credit event has occurred. However, in this respect adequate risk precautions in the case of an "insufficient" credit quality are much more important than in the case of a “good” one. **Using a principle-oriented approach here the financial risk, combined with the principle of prudence, needs to be considered despite the credit rating and the substantial credit change. If the financial risk is affected, it would be worth writing off the value of credit security[27] which can only be done with a principle-oriented approach.**

Summary

- **Fair value (newspeak for the current value) is quite a peculiar concept.** It cannot be used as a **stable-oriented financial system** as it suppresses the principle of prudence
- **IFRS 9 is based on the fair value concept** which again disqualifies the IFRS 9 from being integrated into EU law. One should further question the fulfilment of **true and fair view criteria** in terms of the accounting standards and their reliability.
- It would turn out to be problematic for businesses if the IFRS 9 project were not completely incorporated into EU law due to its 3 level process, and its duration.
- In order to set up a stable-oriented EU regulation vis-à-vis the IASB the duty to provide **fair value valuation of (nonmarketable) equity instruments could be excluded** from being incorporated. Annual evaluation is only for companies within the financial sector.
- **Commercial caution is important for accounting.** The **principle of prudence** not only belongs to the IFRS framework but also to the acquisition criteria of the IAS regulation, which further leads to an impact on **stable-oriented standard settings with a limited use of the fair value**.[28]
- The **expected loss approach of the IFRS 9 is a great improvement** on the incurred loss approach of the IAS 39. However, it is still too **complicated, it is not principle-oriented** and it does not go far enough.
- Within IFRS 9 the step from the first level (12 month expected loss) to the second one (lifetime expected loss) is problematic. The focus should not be on the significant increase in the probability of default, but on the dependability of debt service cover on the balance sheet date. Furthermore, a principle-oriented approach, combined with the principle of prudence would be of use, despite the credit rating and the substantial credit change. **If the credit rating is affected, one should write off the value of credit security. This is what a stability-oriented and principle-oriented value depreciation concept would look like.**

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[27] Andreas Haaker, Nummer 9 lebt! – Auswirkungen des finalen IFRS 9 auf die Bilanzierung von Finanzinstrumenten, Der Betrieb 2014, S. 2792.

[28] Andreas Haaker/Jens Freiberg, Endorsement des IFRS-Rahmenkonzepts? (Pro & Contra), Praxis der internationalen Rechnungslegung 2013, S. 259 f.