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Effect of the global financial crisis on accounting convergence

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Abstract

Fair value accounting (FVA) is threatening the convergence of accounting practices around the world. It has been regarded as one of the contributing factors of the recent financial crisis. Given that International Financial Reporting Standards (IFRS) have embraced FVA, this financial crisis raises concerns about their suitability for financial reporting across the world. This study explores important implications of the global financial crisis for financial reporting, in particular seeking to identify whether the trend towards convergence has been impeded by inherent problems in the IFRS. Contrary to our expectations, analyses show that the financial crisis has made the case for global convergence of accounting standards more compelling than before. The majority of countries intending to converge in the near future have not been affected by the global financial crisis and are committed to adopt IFRS as planned. The analyses also show that the International Accounting Standards Board (IASB) has been facing pressure from the financial institutions, regulators, policy-makers and finance ministers to review its rules on FVA. Consequently, the IASB has been undertaking measures to improve the reporting requirements in the light of the financial crisis.

Key words: Fair value accounting; International Financial Reporting Standards; Accounting convergence; Financial crisis

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1. Introduction

The recent global financial crisis is the result of the confluence of several factors. While some commentators point to the relaxed credit practices of...
banks, others have placed emphasis on the use of fair value accounting (FVA) in financial reporting (Banziger, 2008; Deloitte Touche Tohmatsu 2009). Fair value accounting (also known as ‘mark-to-market’ accounting) is an accounting measurement attribute widely used in both International Financial Reporting Standards (IFRS) and US Financial Accounting Standards (FAS).\(^1\) Fair value is defined as ‘the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction’ (IFRS 3 Business Combinations, p. 3). The use of FVA to recognize assets and liabilities has been subject to much criticism; debate focuses on whether or not and how the current distress in financial institutions is attributable to the application of fair value rules in accounting standards.

The measurements of assets and liabilities have implications for an entity’s financial position. Fair value principles in IFRS tend to replace historical cost accounting (HCA) by using an explicit evaluation of assets according to their expected returns over their lifetime (Boyer, 2007, p. 781). If a market for these assets exists, the market value of the asset is adopted in determining the financial position of the firm. However, when there is no market for these assets, firms rely upon explicit modelling net present value techniques of future earnings or cash flows to get the value of the assets. Models of FVA include the equity approach, the mixed approach, the income approach and the full fair value approach.\(^2\)

According to Ijiri (2005), the use of these models to determine the value of assets gives considerable discretionary power to the users and introduces uncertainty, in these two ways affecting the objectivity of the valuation of the assets. Fair value based on the judgments of future cash flows, for instance, is entity specific, which means that the same asset can be measured differently for two companies because of different borrowing rates and managerial appraisals. Thus, the reliability of fair value estimates declines with the shift from liquid markets to non-traded items (Donker, 2005, p. 2).

Although critics question the reliability of the data on which FVA relies, supporters of FVA argue that fair values for assets or liabilities reflect current market conditions and hence provide up-to-date information, thereby increasing

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\(^1\) Fair value accounting is used in International Accounting Standard (IAS) 16, IAS 17, IAS 18, IAS 19, IAS 20, IAS 26, IAS 28, IAS 36, IAS 38, IAS 39, IAS 40, IAS 41, IFRS 1, IFRS 2, IFRS 3, IFRS 4 and IFRS 7 and is also used in US FAS 107, FAS 115, FAS 140, FAS 144, FAS 142 and FAS 157.

\(^2\) With the equity approach, all unrealized fair value changes are admitted in a revaluation reserve. When the transaction is realized, fair value changes are disclosed in equity. Realized holding gains do not affect the income statement. International Accounting Standard 16 applies this approach. With the mixed approach, unrealized fair value changes are admitted in a revaluation reserve, but realized fair value changes are reflected in the income statement instead of equity. One such example is IAS 39. With the income approach, all holding gains and losses resulting from changes in fair value are reflected in the income statement. In the full fair value model, all fair value changes are reflected in the income statement, including internally generated goodwill.

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transparency by adequate flow of relevant information and encouraging prompt corrective actions by the users of such information. This also enhances investor confidence in the capital markets. But does FVA actually promote transparency by providing the relevant information to the users? According to Krumwiede (2008, p. 34), FVA has not led to the increased transparency in financial reporting as was expected by the users of the information.

Critics of FVA argue that FVA significantly contributed to the financial crisis and exacerbated its severity for financial institutions in the United States and around the world.3 For example, many in the banking sector have argued that although fair value gives at each instant a seemingly relevant liquidation value, it obscures the value creation process by mixing present profit with unrealised capital gains and losses (Boyer, 2007, p. 779). Opponents of FVA also claim that fair value is not relevant and is in fact potentially misleading for assets that are held for a long period and, in particular, assets held to maturity. Prices for such assets could be distorted by market inefficiencies, investor irrationality or liquidity problems. Moreover, it has been argued that because fair values based on models are not reliable, FVA contributes to the procyclicality of the financial system (Laux and Leuz, 2009, p. 831). That is, it exacerbates swings in the financial system; it may even cause a downward spiral in financial markets. For example, FVA and asset write-ups allow banks to increase their leverage in booms, which in turn makes the financial system more vulnerable and financial crises more severe (see Persaud, 2008; Plantin et al., 2008).

In May 2008, the International Accounting Standards Board (IASB) established an external expert advisory panel to review the accounting issues emerging from fair value reporting from the global financial crisis. The aim of the panel was to create a single standard that measures fair value where existing standards require or permit the use of FVA (IASB, 2009, p. 3). Based on the recommendations of the panel, the IASB published proposals, in IFRS 7 Financial Instruments Disclosures, to improve the fair value disclosures. Similarly, the US government’s $US700 billion bailout packages required the SEC to perform a study on the impact of FVA on financial institutions and to suspend the practice, if necessary. On 30 December 2008, the SEC delivered a report (mandated by the Emergency Economic Stabilization Act) on mark-to-market accounting standards and their application to financial institutions. Although report concluded that FVA standards should not be suspended, recommendations were made

3 For example, the American Bankers Association in its letter to the Securities and Exchange Commission (SEC) in September 2008 stated that ‘‘the problems that exist in today’s financial markets can be traced to many different factors. One factor that is recognized as having exacerbated these problems is fair-value accounting.’ Similar concerns are also shared by the US Congress, which exerted strong pressure on the Financial Accounting Standards Board (FASB) to change the accounting rules. See also Forbes (2009), Wallison (2008a,b) and Whalen (2008) for discussion of fair value accounting and the financial crisis.

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to improve their application (Dunn, 2009, p. 2). For example, the report recommended reconsideration of accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

Regional and national accounting regulators have also raised concerns about the application of FVA in IFRS. For example, a major issue identified by the European Union (EU) countries surveyed on factors affecting convergence has been the complicated nature of certain IFRS, especially those employing FVA (Larson and Street, 2004, p. 92). European officials, especially in France and Germany, threatened to carve out exemptions from IFRS unless changes were made to fair value rules in IAS 39. Additionally, during the process of accounting convergence in China in 2007, problems such as manipulation of earnings were associated with FVA and as a result restrictions were placed on the use of FVA (Li et al., 2007, p. 13). The Chinese regulators informed listed companies in China to apply FVA models prudently and reasonably (Wang, 2006, p. 29). As such, Chinese standard setters took a conservative attitude regarding the application of FVA. For instance, revaluation applies only to subsequent measurement of investment properties. For tangible and intangible assets, cost model must be chosen, and revaluation is not allowed.

Given that IFRS have embraced FVA, the current financial crisis has raised concerns about their suitability for financial reporting across the world. This exploratory study highlights important implications of the global financial crisis for financial reporting, particularly identifying whether the trend towards convergence has been impeded by inherent problems in IFRS. The study focuses in particular on the definition of FVA and its use in IFRS. Our analysis shows that the financial crisis has not impeded the trend of convergence; most countries intending to converge in the near future have not been affected by the global financial crisis and are committed to proceeding with the adoption of the IFRS as planned. However, the controversy surrounding the use of FVA and its impact on the global financial crisis has led to a number of criticisms of IFRS, and the IASB is undertaking measures to improve the reporting requirements in IFRS. For instance, in response to concerns about fair value measurements in illiquid markets, the IASB set up an Expert Advisory Panel to identify best practices for estimating fair value in illiquid markets and for disclosure, and afterwards in May 2009, it published an exposure draft on fair value measurement.

The findings of this study are important because they provide insight into how FVA brought on or deepened the crisis and how the regulators are going to rein in or define the use of FVA. The paper also highlights important considerations for other countries that are planning to converge with IFRS but have expressed reservations owing to the current financial crisis.

The remainder of the paper is organised as follows. The next section outlines the process of accounting convergence. The third section provides a discussion on the use of FVA in IFRS. The fourth section provides an analysis of FVA in the light of current financial crisis, while the fifth section presents an examination
of the effect of the credit crisis on the future of accounting convergence. Finally, in the sixth section, the paper draws a number of conclusions about the effects of financial crises on accounting convergence.

2. Accounting convergence

Accounting convergence refers to the ‘process of narrowing differences between IFRS and the accounting standards of countries that retain their own standards’ (Ball, 2006, p. 9). A survey by Deloitte Touche Tohmatsu (2009) reported that more than 100 nations have adopted IFRS either partially or in their entirety for their domestic listed companies. For example, the Australian Accounting Standards Board (AASB) adopted the Australian equivalent of IFRS (AIFRS) for all its reporting entities effective from 1 January 2005. New Zealand used a similar approach in adopting IFRS from 2007. The mandatory adoption of IFRS by listed companies for consolidation in the EU from 2005 is also an important example of accounting convergence. According to the EU Parliament, ‘a single set of accounting reporting standards is regarded as essential to ensure a high degree of transparency and comparability of financial statements and hence the efficient functioning of the EU capital market’ (EU Parliament, 2002).

A number of other prominent countries that have yet to adopt IFRS have established convergence projects that will most likely lead to their adoption of IFRS in the near future. For example, countries expected to adopt IFRS in the near future include Chile (2009), Korea (2009), Brazil (2010), India (2011), Japan (2011), Canada (2011), Malaysia (2012) and the United States (2014). For example, since 2007, Canada has allowed foreign companies to use IFRS. In November 2007, the SEC announced that it will allow non-US companies to file financial results according to IFRS without reconciliation to US Generally Accepted Accounting Principle (GAAP) (IASB 2007). Moreover, since 2008, the SEC has given US companies the choice of preparing financial statements under either IFRS or US GAAP. The plans of these countries to converge with IFRS show that there will be a notable increase in the number of countries using IFRS in future.

A growing interest in convergence also comes from all participants in the capital markets. For example, according to a survey conducted by the International Federation of Accountants (IFAC) in 2007, a large majority of accounting leaders, who include mainly policy-makers and chief executives of large corporations from around the world, agreed that a single set of IFRS is important. Of the 143 leaders from 91 countries who responded, 90 per cent reported that IFRS was ‘very important’ or ‘important’ for economic growth in their countries. In 2005, the EU carried out a survey of executives of Italian listed companies, seeking their views on accounting convergence. According to the respondents, communicating to the stakeholders using IFRS enhances confidence in businesses and improves finance-raising capabilities. IFRS also allows companies to benchmark themselves against their peers, allowing investors to compare firm performance with competitors globally (Cordazzo, 2008, p. 3).
Additionally, convergence offers substantial benefits to large companies, both locally and internationally (Thomas, 2009). For example, convergence promises to produce efficiencies, simplification and cost savings for large companies by eliminating dual reporting. United Technologies, a $50 billion global company in the United States, for instance, claims that it needs to use IFRS to address its competition aggressively (SEC, 2007). Convergence is thought to eliminate costly reconciliations (KPMG, 2008) and enhance U.S. global competition (SEC, 2007). Furthermore, professionals and regulators would deal with a single set of standards, which would lead to a reduction in differences in accounting standards between countries, and thus, more transparent financial statements would be prepared (Nicolaisen, 2005). Convergence would offer investors the additional benefit of enabling more efficient international trading. Accounting convergence is also seen as a means to encourage strong, stable and liquid capital markets, hence increasing investor confidence and producing greater global acceptance of company financial statements (SEC, 2007).

Despite the tangible benefits, there are also costs involved with accounting convergence. In most cases, convergence costs have far exceeded what was initially anticipated. For example, in the United States, United Technologies, one of the big companies thinking of converging with IFRS, estimates that switching to IFRS from US national GAAP will cost them 2 to 3 years of effort and 5 percent of revenue. Moreover, Chalmers et al. (2007) found that companies shifting from Australian Accounting Standards to IFRS incurred significant financial and other costs, including a 10 percent lower book value for equity. Changing accounting policies in accordance with IFRS also affects tax liability. A company’s tax liability may change simply because the numbers on the balance sheet or the income statement change. In other cases, IFRS may change the amount of deferred tax recognised in financial statements. For example, when a company’s pension liability changes significantly as a result of adopting IFRS that alters the deferred tax liability to be reported (SEC, 2007). There are also issues concerning the legal and regulatory environment of the countries adopting IFRS. Companies need to discuss their adoption of IFRS with regulators and lenders and potentially establish new guidelines for current covenants. Investors also need to be informed of changes owing to the adoption of IFRS, and results need to be reconciled with current accounting practices. All of these processes require significant resource expenditure (SEC, 2007).

In addition to the challenges outlined above, the effect of FVA rules on the financial crisis has emerged as another issue that has gained worldwide attention. The next section provides a detailed analysis of the use of fair value in IFRS.

3. Use of FVA in IFRS

IFRS brought in a revolution in accounting practices by moving away from established concepts of HCA and towards concepts of investor decisions based on future cash flows and fair values (Williams, 2002, p. 1). Up until the 1970s,
HCA had been the conventional measurement technique supported by professional accounting bodies, accounting laws and regulations. However, there were many criticisms of HCA, particularly in relation to its inability to provide useful information during times of changing prices. The pervasiveness of the issue came to the fore when the global economy went through a period of seemingly intractable inflation in the 1970s (Sterling, 1970; Edward, 1975). The critics of HCA opted for other measurement techniques that were market value based rather than cost based and were considered as providing more relevant information than that which was available under the conventional HCA.

Fair value accounting, a market-based measurement technique, has been part of GAAP for many years now (Cheung and Morley, 2008, p. 2). Since the 1970s, FVA has been gaining legitimacy as accounting standards that require its application began to be released in various jurisdictions. For example, fair value was first mentioned in IAS in 1977, in the context of IAS 17 Accounting for Leases (International Accounting Standards Committee (IASC), 1982a). In IAS 17, fair value played a role in determining the classification of a lease as finance or an operating lease, as well as in the determination of profit or loss in sale and lease-back transactions. Other standards made reference to fair value as well. For example, in IAS 16 Accounting for Property, Plant and Equipment, fair value is defined as ‘the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm’s length transaction’ (IASC 1982b, p. 6).

Additionally, in 1995, the IASC signed an agreement with the International Organisation of Securities Commissions to develop a set of new standards that would form an acceptable basis for reporting purposes for companies with cross-border listings, and as a result of this agreement, the use of fair value became quite pervasive. For instance, in 1999, the IASC issued IAS 39 Financial Instruments: Recognition and Measurement requiring the use of FVA, but this was received with scepticism by the banking industry. The main argument against fair value was that there would be an increase in volatility in financial statements. However, the move towards a more extensive use of fair value progressed despite the criticisms against it. Then, in 2003, the IASB amended IAS 32 and IAS 39 and released the revised versions, providing organisations with the irrevocable option to apply FVA (Chorafas, 2006). These examples illustrate the shift towards the adoption of the FVA model and the beginning of the trend towards the large-scale adoption of FVA in mainstream accounting practices.

Table 1a shows the current IAS/IFRS that require the use of fair value measurement (including accounting for derivatives, held-for-trading and available-for-sale financial assets and some biological assets), whereas Table 1b shows the IAS/IFRS that allow a choice of either fair value measurement or historical cost-based measurement (accounting for property, plant and equipment, investment property, intangible assets and other financial assets and financial liabilities). For example, IAS 16 Property, Plant and Equipment allows a choice between the cost model and the fair value model in the measurement of property,
plant and equipment. An entity that selects the revaluation model measures items of fixed asset at fair value. Therefore, it is not mandatory for an entity to carry fixed assets at fair value.

Additionally, in IAS 40 Investment Property, subsequent to initial recognition at cost, IAS 40.30 requires firms to choose between the cost and fair value models and to apply the chosen policy to all of their investment property. On the other hand, IFRS 2 Share-based Payment requires companies to recognise an expense in relation to employee compensation involving shares or share options and to measure this expense at the fair value of the shares or options at grant date. Furthermore, IAS 41 Agriculture requires that biological assets are measured on acquisition and at subsequent balance sheet dates at fair value less costs to sell, unless the entity determines on initial recognition that fair value cannot

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4 IAS 40 allows two exceptions, both quite restrictive, by which firms may report part of their property portfolio under the cost model and part under the fair value model. However, as a practical matter, most firms apply either the cost or fair value models to their full portfolio of investment properties.

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be determined reliably. Harvested agricultural produce is always measured at fair value less costs to sell.

The IASB’s approach to fair value places emphasis first on quoted prices in active markets, that is at level one input. An active market is when the entity has an immediate access to the market (could exchange in current condition of the asset or liability) and in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis (IASB, 2009). Examples of active market are the capital market and the commodity exchange market. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available. If a quoted price for fair value is not available, the valuation is then based on market observations. This means that the estimate for the asset or liability would consider prices for similar assets or similar liabilities with essentially the same characteristics, including the same expected cash flows, that is at level two input. It is recognised that an entity might have to make significant adjustments to an observed price in order to arrive at the price at which an orderly transaction would have taken place (IASB Expert Advisory Panel, 2008).

In the absence of quoted prices in active markets, the valuation is based on non-observable assumptions, that is at level three input. The IASB requires the use, when possible, of market information and favours widely used and accepted valuation techniques. However, significant assumptions or inputs used in the valuation technique are based upon inputs that are not observable in the market and, therefore, these information necessitates the use of internal information. The entity may rely on internal information only if the cost and effort to obtain external information are too high. In addition, financial instruments must have an input that is observable over the entire term of the instrument. Table 2 shows in detail the hierarchy for fair value disclosures.

Fair value accounting has gained credence because investors perceive fair value estimates as more value relevant than historical cost amounts (Barth et al., 2001). The framework of principles from the IASC (IASC, 1989) prescribes that company reports are produced to enable users to make economic decisions and that those decisions concern an estimate of the enterprise’s future cash flows. If investors are provided with information about future cash flows to make judgements about their investments, the accounts will also reflect economic reality (Damant, 2001). The use of FVA also encourages banks to follow a fair value measurement for assets and liabilities. Under such an approach, all financial instruments including loans will be measured and recorded at their fair value. Any changes (gains/losses) arising from changes in fair values as a result of changes in the underlying environment will go directly to a bank’s income statement. In this way, ‘embedded’ losses and/or gains are fully recognised in the accounts. This dictates that FVA will help to alleviate problems of the stewardship function as long as market participants possess that knowledge or the necessary financial analysis tools (Casabona et al., 2001).
Table 2
The Hierarchy of fair value disclosures

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<th>Level 1</th>
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<td>Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.</td>
<td>Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include: — Quoted prices for similar assets or liabilities in active markets; — Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market); — Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates); — Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).</td>
<td>Level 3 inputs are unobservable inputs for the asset or liability Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability Therefore, unobservable inputs shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk) Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity’s own data In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity’s own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions</td>
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Based on IASB (2009).
Furthermore, IFRS require fair value measurements with the intent of enhancing the relevance of reported numbers. According to Ball (2006), fair values contain more information than historical costs in financial statements. Incorporating more information in financial statements by definition makes them more informative, with potential advantages to investors, which, other things being equal, makes them more useful for purposes of contracting with lenders, managers and other parties. Moreover, both the IASB and FASB seem determined to push ahead for FVA. For example, one of the FASB members commented that:

The Board [FASB] has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors and creditors than historical cost information. Such measures better reflect the present financial state of reporting entities and better facilitate assessing their past performance and future prospects. In that regard, the Board does not accept the view that reliability should outweigh relevance for financial statement measures... Noisy information on gains and losses is more informative than none, so even the least reliable 'mark to model' estimates certainly incorporate more information. Johnson (2005, p. 4)

In view of such developments, it appears that accounting regulators have been increasingly replacing historical costs with fair values obtained both from liquid market prices and from model-based estimates. However, for assets, liabilities or equity instruments that are not traded in active markets and for which market information is not available, the estimation of fair value is likely to be difficult. Consequently, a key issue is whether a fair value measurement can be accepted as having sufficient reliability. Because FVA has been regarded as a contributing factor in the current global financial crisis, the next section provides an evaluation of FVA.

4. Assessment of the effect of FVA on the global financial crisis

4.1. Criticisms of FVA

Recently, FVA has drawn much attention worldwide and has been heavily criticised for its role in the global financial crisis (de France, 2008; IMF, 2008). Specifically, the financial crisis has ignited fierce debate about the effect of fair value reporting in turbulent and illiquid markets (Mallet, 2008, p. 1). The lack of organised and liquid markets for many assets and obligations poses difficulties in developing reliable fair value measures. For instance, many assets of financial institutions (such as loans) are illiquid, not standardised and are not traded in deep markets. Subsequently, in these illiquid markets, trading by managers can influence the quoted prices and hence allow them to manipulate fair value estimates. According to Ball (2006), when market prices are not available, estimates using fair value models are used to derive the fair value and not the actual arm’s length market prices. These fair value models, as defined previously, incorporate
numerous assumptions, and trivial changes can lead to substantial alterations of income. This introduces ‘model noise’, owing to imperfect pricing models and imperfect estimates of model parameters. For example, estimates of future cash flows provide room for subjective judgments or manipulation of the values. Hence, fair values can be unreliable because of the intrinsic error in either the measurement tool or the input to the tool.

Moreover, market prices are not readily available for bank assets and liabilities such as ‘middle-market’ business loans, commercial real-estate loans and some sovereign debt (Bernard et al., 1995; Chen et al., 2005). As a consequence, a company’s credit rating deterioration leads to a decline in the fair value of that company’s liabilities for instance, and if they were included at fair value, this would create a profit at a time when the company’s performance or prospects may have worsened. This suggests that the valuation procedures should be symmetric and hence unbiased (Merton and Bodie, 1992). The former US SEC chief accountant has commented, in response to banks’ assertions that FVA is the cause of the problem, that:

…the only thing FVA did is force you to tell investors that you made a bunch of very bad loans. (Cheung and Morley, 2008, p. 51)

Additionally, some of the major companies’ fair values have wiped out reported profits, or have increased losses by forcing them to report their assets according to the current market, or modelled prices (James, 2009). For example, one of the private equity billionaires, in an interview with the Financial Times, called FVA standards ‘absurd and destabilising’ (Chartered Institute of Management Accountant (CIMA) 2009, p. 1). Another commentator of the American Federation of Labor – Congress of Industrial Organisations also observed that:

…mark-to-market seems to apply when the market is liquid but can be naïve and misleading. Fair value accounting breaks down when the trading slows and there is no market to mark to which then leads to mark-to-model and eventually ‘mark-to-mush.’ (Brown, 2008, p. 2)

Furthermore, fair value does not require a transaction to have occurred to recognise the change in value, so it can recognise profits and losses earlier than under the historical cost approach. This has led to criticisms that fair value adds to the ‘pro-cyclicality’ effect by amplifying the effects of the business cycle. For example, Enron used FVA in highly creative ways in a number of different circumstances. One of the first examples of Enron’s use of FVA involved a long-term gas supply contract. The Task Force of the FASB issued a consensus document that allowed companies to use FVA with respect to long-term energy contracts. This ruling enabled Enron to record $34 million of fair value of income, and because Enron controlled the gas market, it could use its own estimates to manipulate the amount of revenue that it recognised (Benston, 2006).

Moreover, critics of FVA have accused it of ‘pouring fuel on the fire’ rather than simply ‘measuring the flame’ (Washington Post, 2008, p. 1). That is, simply
reporting mark-to-market losses can cause further declines in market values, which can in turn affect losses reported by investors (Cheung and Morley, 2008). According to a former chairman of the US Federal Deposit Insurance Corporation, the economy is in deep trouble owing to its accounting system:

...mark-to-market is the primary causes of the worldwide financial crisis and should be withdrawn immediately as ‘hundred of billion dollars’ have been lost because of these rules... Mark-to-market accounting would interfere with banks performing their fundamental function of taking relatively short-term deposits and converting them into relatively long-term loans to businesses and consumers. (Dzinkowski, 2009, p. 49)

Fair value accounting requires companies to mark their financial instruments at market prices and can reflect bad news somewhat unmercifully. For example, if the current price is much lower than the original cost, then large write-downs can appear on balance sheets. These apparent losses can lead to a lack of confidence, especially if there is no ‘market’ to provide a value at all. Critics of FVA also argue that the rules have been exacerbating the global financial crisis by further depressing financial assets and making it harder for companies to access capital in markets where capital has evaporated (Hoonttrakul, 2008). For example, since the mid-1990s, several countries have adopted the FVA, which are acceptable in markets that are functioning well (ibid.). However, markets have become dysfunctional in the wake of the global financial crisis, as evidenced by the sharp fall in the price of equities, and as a result, most balance sheets look dismal.

The effect of the current financial crisis is also felt by the auditors. During times of market uncertainty, an audit alert is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to assist auditors by highlighting areas within the International Standards on Auditing that are particularly relevant in the audit of FVA estimates. Such alerts are prepared in the light of current difficulties in the credit markets and therefore focus on financial instruments (IAASB, 2008, p. 1). Auditors are expected to be aware of the need to understand the rules relating to FVA, including disclosures, and to give appropriate consideration to their application. For example, France National Accounting Board and PricewaterhouseCoopers partners, Etienne Boris and Didier Marteau, commented that they strongly opposed the way fair value is applied during a crisis (Sukhraj, 2008). They suggested an ‘upgraded fair value’ which would stop pro-cyclical effects of mark-to-market and would allow trading assets to be measured consistently with their intrinsic values. They argued that the rule could be applied to impaired assets or structured instruments whose underlying assets were impaired, such as ‘sub prime’ assets.

Overall, our review illustrates that the use of fair value appears to be criticised widely and continuously identified as one of the causes of the current financial crisis. However, to draw any legitimate conclusions on the effect of FVA on the financial crisis, it is imperative to consider arguments in its favour, which is outlined in the next section.
4.2. Arguments in support of FV

Even though FVA has been largely blamed for its role in the global financial crisis, there are nevertheless significant advantages of and much support for its use. O’Hara (2009, p. 3) states that although FVA is not perfect, it portrays the value of assets available for sale or trading to investors in a more relevant and timely manner than figures based on HCA. Proponents of FVA also acknowledge that fair value rules are not ideal but argue that they are better than any existing alternative and provide much needed transparency for investors (Brown, 2008). For example, according to the head of PricewaterhouseCoopers, fair value rules help to provide transparency to investors, and if there is a loss of transparency, the risk of litigation increases: every time there is a failure, the questions will be ‘Where were the accountants? Why wasn’t this transparent?’ (Hughes, 2009, p. 1).

International accounting experts have also backed fair value, refusing to endorse views that the standard be rejected in favour of historical cost values. According to a survey of Chartered Financial Analyst members worldwide, conducted in 2008, 79 percent of respondents believed that fair value requirements improve transparency and contribute to investor understanding of financial institutions’ risk (IASB, 2008). The supporters of the fair value model also believe that fair values give users of financial statements more useful information than other measures, such as depreciated cost, and changes in fair value are inextricably linked as integral components of the financial performance (International Accounting Standards Conceptual Framework (IASCF), 2008).

Moreover, professional bodies, such as Certified Professional Accountant (CPA) Australia are also of the view that, for some assets and liabilities, their measurements at the fair value yield better ‘decision-useful’ financial information than historical costs, for example, derivatives (Rankin, 2009). CPA Australia also strongly believes that the use of fair value derivatives and some financial assets reflected at fair values is the most effective method to reflect economic reality of such items. According to Rankin (2009), fair value can be difficult to determine in current market conditions, but the benefits it brings of transparency and comparability are undisputed. He argues that ‘the function of fair value financial reporting is like that of the thermometer – it mirrors reality, it does not create it’ (Rankin, 2009, p. 10).

Additionally, one of the directors of CPA Australia argues that HCA is a flawed approach to evaluating financial assets and financial liabilities, simply because its relevance becomes valueless over time. He states that, notwithstanding the fact that it is difficult and challenging to come up with values, particularly in illiquid markets, that does not impair the relevance of FVA as probably the best measurement attribute for financial assets and financial liabilities (CPA, 2009, p. 22). Moreover, a JP Morgan analyst comments that ‘blaming FVA for the credit crisis is like going to a doctor for a diagnosis and then blaming him for telling you that you are sick’ (Hinks, 2008, p. 2). He points out that FVA
and enhanced disclosures have helped markets to identify quickly where problems exist and to respond to those problems, suggesting that the world’s current financial situation might be worse in the absence of FVA, because the magnitude of the problems would not have been recognised as quickly under traditional accounting methods. Furthermore, according to that analyst, if FVA had been instituted earlier (and if the credit risk had been captured appropriately in the market values), the financial crisis would have been avoided (Wallace, 2009, p. 15).

Ryan (2008, p. 1608) proposes that the best way to stem the credit crunch and damage caused by these actions is to speed the price adjustment process by providing market participants with the most accurate and complete information about subprime positions. Although imperfect, nonetheless FVA would provide better information about these positions and is a far better platform for mandatory and voluntary disclosure than alternative measurement attributes, including any form of amortised cost accounting.

One of the most important qualities of information is that it is meaningful to its users. If fair value were not meaningful, then it would provide no information that is useful to investors regarding the underlying economic value of the securities that are carried at ‘fair value’. For example, the decline in the fair values of the mortgage securities issued in recent years is entirely consistent with the emergence of significantly higher default rates on these securities versus the expected defaults at the time of issue. Therefore, the fair value information regarding these securities cannot be regarded as meaningless, as it provides an estimate of the impact of higher defaults on current earnings (Wallace, 2009, p. 17).

The views described above show that there are proponents of fair values who strongly support FVA, and its endorsement by the IASB in IFRS. Those who support the use of FVA believe that information about financial assets’ and liabilities’ fair value is more relevant than historical cost. Fair value reflects the amount at which an asset can be bought or sold and provides a better indication of current risk. As a result, investors and other decision makers can exercise better market discipline and corrective actions regarding a company’s decisions. Having surveyed both the pros and cons of FVA during the financial crisis, we next assess the impact of FVA on accounting convergence.

5. IASB’s response to the financial crisis and impact of FVA on the future of accounting convergence

5.1. IASB’s response to the financial crisis

The global financial crisis has served as a wake-up call to financial institutions, regulators, policy-makers and finance ministers worldwide (IASB, 2009). Above all, it has been pressing the IASB to review its rules on FVA (Imeson, 2008, p. 1). Initially, the IASB opposed any changes to the fair value rules, claiming that any relaxation in the fair value rules would cloud the picture for investors.
and regulators and could sow the seeds of the next crisis (Imeson, 2008). However, because of the continued pressure from the financial institutions, policy-makers and finance ministers of prominent countries, IASB reconsidered its decisions and responded by taking unprecedented steps, in a considered fashion, to the crisis (So and Smith, 2009, p. 103). The speed of the actions to change or augment financial reporting standards reflected the urgency of the situation and provides insights into how the boards function in crises.

Currently, the IASB is working closely with the Financial Stability Forum (FSF), which has been designated by public authorities to manage the regulatory response to the crisis (Tweedie, 2008). The FSF has made a number of recommendations to enhance the resilience of the market, and the three that formed the core of the IASB’s response to the credit crisis are that the IASB should: (i) improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters towards international convergence; (ii) enhance its guidance on valuing financial instruments when markets are no longer active; and (iii) strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations (IASB, 2009). The IASB is working expeditiously on these recommendations.

In response to concerns about fair value measurements in illiquid markets, the board set up an Expert Advisory Panel to identify best practices for estimating fair value in illiquid markets and for disclosure. In October 2008, the IASB bowed to pressure from the European regulators and relaxed its position on FVA by allowing companies to transfer non-derivative financial assets out of classifications that are reported at fair value into categories that use amortised cost to value assets (Bogoslaw, 2008). International Accounting Standards Board rationalised the amendment by saying it would create a level playing field with an existing FASB standard, Statements of Financial Accounting Statements 115, which permits companies ‘in rare circumstance’ to make the same transfer. The IASB argued the current financial crisis essentially qualifies as rare circumstance because of the illiquid marketplace for financial products (Bogoslaw, 2008). Subsequently, by 31 October 2008, the IASB published educational guidance on fair value measurement of financial instruments in markets that are no longer active. It confirms the guidance published as a result of discussions by an Expert Advisory Panel created by the IASB in 2008. The proposed guidance is also consistent with existing US requirements, including recent amendments.

5 For example, the EU pressure to look again into the FVA rules.

6 The FSF comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions, standard setting bodies, and committees of central bank experts.

7 The educational guidance is available at http://www.iasb.org.

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Afterwards in May 2009, the IASB published an exposure draft on fair value measurement. The proposed guidance deals with how fair value should be measured where it is required by existing standards. If adopted, the proposals would replace fair value measurement guidance contained within individual IFRS with a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in inactive markets. Introducing the exposure draft, Sir David Tweedie, Chairman of the IASB, said:

This exposure draft is an important milestone in our response to the global financial crisis. The proposed guidance proposes clear and consistent guidance for the measurement of fair value and also addresses valuation issues that arise in markets that have become inactive. This guidance is consistent with the report of the Expert Advisory Panel and with US GAAP and would achieve overall convergence with US GAAP. (IASB, 2009)

Moreover, the IASB’s IAS 39 Financial Instruments regulates how financial instruments are measured and is one of the standards that have gained worldwide attention. To address the concern on financial instruments, a number of steps have also been taken by IASB. According to the British Bankers’ Association (BBA), accounting standards setters must recognise that fair value is not always appropriate for valuing financial instruments. It wrote to the IASB in September 2008 advocating a mixed-measurement model, which would continue to use the fair value method for some instruments, such as those held for trading purposes, and more relevant methods for those such as longer-term loans. The BBA asked the IASB to make fast-track changes to IAS 39. These changes included a review of how different classes of assets are valued and, in particular, it included the immediate suspension of paragraph 50 of IAS 39, prohibiting recategorization from trading (Imeson, 2008).

Accordingly, on 13 October 2008, the IASB took the unprecedented step of amending IAS 39 without first issuing the changes in the form of an exposure draft for public comment. This move was in direct response to pressure from the EU, which had threatened to go ahead with its own ‘carve-out’ if necessary (IAS Amendments, 2008). The amendments were described by the IASB as ‘addressing the desire to reduce differences between IFRS and US GAAP’ (KPMG, 2008). In this regard, the amendments relaxed the prohibition in IAS 39 on reclassifying financial assets that were carried at fair value to allow reclassification of non-derivative financial assets in certain limited circumstances. In approving the amendments, the IASB has also introduced new disclosure requirements under which companies exercising the reclassification option will have to show what would have been the effect on their financial statements had they not chosen to make reclassifications. The purpose of the amendments is to level the playing field between IFRS and US GAAP. The amendments give companies applying IFRS the option that already existed under US GAAP. The amendments, which are summarised in the Table 3, took immediate effect, with back-dating of reclassifications to 1 July 2008 being permitted.
Moreover, the EU ministers continued to apply pressure on the IASB to make further changes to IAS 39. On 27 October 2008, the EU wrote to the IASB setting out further amendments, which they considered should be made in time for the publication of the year-end results. In particular, they were seeking to expand the reclassification concession to those assets that were voluntarily classified at fair value even though not held-for-trading at the time and to amend the impairment rules. Unlike the October 2008 amendments, these further changes would not result in greater convergence with US GAAP. Currently, both IFRS and US GAAP employ mixed attribute models that are the product of many compromises over the years. Some financial instruments are measured at fair value with changes reflected in earnings; other instruments are measured at fair value with changes outside of earnings; and still others are measured on a historic basis (amortised cost) (Financial Crisis Advisory Group, 2009).

The above analyses show that the IASB has been reviewing the accounting standards according to the needs of its users. According to the IASB, financial statements must contain information that should enhance transparency for investors and hence improve the ability and willingness of an investor to take an investment decision. According to Financial Reporting Blog (2009, p. 1), the financial crisis has emphasised the relevance of the IASB’s mission and it gives the impression that more than ever, there is a need for a single set of worldwide

<table>
<thead>
<tr>
<th>Reclassification between measurement categories</th>
<th>US GAAP</th>
<th>IAS 39 (Amended)</th>
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<tbody>
<tr>
<td>In rare circumstances, reclassification of securities no longer held for the purpose of selling or repurchasing in the near term out of the fair value through profit or loss category into cost-based categories</td>
<td>Already permitted</td>
<td>Now permitted</td>
</tr>
<tr>
<td>Reclassification to loans and receivables category (cost-based category) from fair value through profit or loss or available for sale categories if the entity has the intention and ability to hold the financial assets for the foreseeable future or until maturity</td>
<td>Already permitted</td>
<td>Now permitted</td>
</tr>
<tr>
<td>Reclassification to a cost-based category if the entity originally elected under the ‘fair value option’ to include the financial asset in the fair value through profit or loss category</td>
<td>Not permitted</td>
<td>Still not permitted</td>
</tr>
</tbody>
</table>

GAAP, Generally Accepted Accounting Principle; IAS, International Accounting Standard; IFRS, International Financial Reporting Standards.
accounting standards. Consequently, the next section investigates the reactions of those countries that are planning to converge in the near future and reveals whether the financial crisis is impeding their plans for accounting convergence.

5.2. Impact of FVA on the future of accounting convergence

Major economies in Asia-Pacific (Japan, India and Malaysia), North America (Canada), Central America (Mexico) and South America (Argentina, Brazil and Chile) have established a timeline towards the full adoption of IFRS. However, central to these countries’ plans to adopt IFRS is consideration of the effect of financial crisis, particularly, the concern about the use of FVA in IFRS and its role in the financial crisis. Responses from selected countries planning to adopt IFRS in the near future are summarised in Table 4, taking into consideration the imperfections found in FVA.

All the countries that have prepared roadmaps to convergence appear to remain firm with their plans of accounting convergence. For example, in September 2009, the Accounting Standards Board of Japan (ASBJ) and IASB reaffirmed their ongoing cooperation in achieving convergence in accounting standards. Led by Ikuo Nishikawa, Chairman of the ASBJ, and Sir David Tweedie, Chairman of the IASB, this tenth meeting was to accelerate convergence of Japanese GAAP and IFRS (IASB, 2009). As part of the meeting, representatives of the IASB provided an update on the measures that are being undertaken by the IASB in response to the financial crisis. The roadmap permits early adoption of IFRS by listed companies for fiscal years beginning 1 April 2009 and proposes mandatory adoption of IFRS from 2015 or 2016.

Korea’s decision to embrace IFRS fully has provided further evidence that Asia is a firm believer in global standards. Korea has decided that from 2009, any company can choose to apply IFRS, with the use of IFRS becoming mandatory for all listed companies from 2011. According to accounting regulators in Malaysia, convergence with IFRS will enhance the national reputation of Malaysian accounting practice. Establishment of this profile is imperative to ensure Malaysia is not left out of the globalisation wave, especially because more than 100 countries are converging or have converged with IFRS (MASB, 2008).

Moreover, regarding the transition to IFRS, Canada’s Accounting Standards Board (AcSB) has reviewed the comments received at the roundtable meeting consisting of all interested parties such as regulators, policy-makers and finance ministers that took place on 20 April 2009 in Montreal. After considering the input received about the challenges of adopting IFRS, the AcSB concluded that there were no compelling arguments that would require delaying the changeover date. It reaffirmed that Canadian GAAP for publicly accountable enterprises will be IFRS for interim and annual financial statements relating to fiscal years beginning on or after 1 January 2011.

Moreover, the IASB and FASB have been working on a number of major convergence projects. In response to the financial crisis, the two bodies have
<table>
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<th>Country</th>
<th>Proposed date for convergence</th>
<th>Comments on the impact of credit crisis on the proposed timing of convergence</th>
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<tbody>
<tr>
<td>United States</td>
<td>2014</td>
<td>Despite a US plan to adopt IFRS by 2014, the head of the IASB says global, economic and political pressures may force the United States to adopt by 2011 (Mitra, 2009). Adoption of international accounting standards for all listed US companies will not be achieved by 2011, says Financial Reporting Council’s (FRC’s) chief executive, Paul Boyle (April, 2009). When the Securities and Exchange Commission announced an interest in moving US companies to IFRS, corporations and accounting firms realised the move from US GAAP would be costly and time-consuming. However, because of the economic and credit crisis, the transition is likely to be even more challenging (Street, 2009). The IFAC applauded the call by the US President for the urgent progress towards the ‘development of a single set of high-quality global accounting standards.’ These standards were one element of the proposal for regulatory reform, issued at a press conference on Wednesday, that Mr. Obama called ‘necessary to avoid another financial crisis.’ Ian Ball, Chief Executive Officer, IFAC said that the president’s acknowledgment of the importance of developing a high-quality set of global accounting standards reflects the importance of global standards and a level playing field in financial reporting (Accounting Education News, 2009, p. 4).</td>
</tr>
<tr>
<td>Japan</td>
<td>2011</td>
<td>The IASB Chairmen has met with its Japanese counterpart in the hope of achieving convergence between their rules by 2011. In the ninth meeting in February 2009, the event focused on the convergence of Japanese GAAP and IFRS. Mr Nishikawa said: ‘In Japan, the potential use of IFRS by Japanese companies has been discussed since last year. From those discussions, it is clear that constituents wish us to accelerate our convergence project so as to complete it by the end of June 2011’ (Chartered Institute of Management Accountant, February, 2009). Commenting on the tenth meeting (September, 2009) Ikuo Nishikawa, Chairman of the Japanese Accounting Standards Board (ASBJ), said: ‘The IASB and the ASBJ again had a useful meeting that included a productive discussion on cross-cutting issues. The ASBJ continues to participate actively in the international standard-setting process, including this regular meeting with the IASB. This is also consistent with the Interim Report issued by the Business Accounting Council, which sets out a roadmap towards the application of IFRS in Japan and recommends that the ASBJ continues and accelerates the convergence of accounting standards’ (IASB, 2009).</td>
</tr>
<tr>
<td>Country</td>
<td>Proposed date for convergence</td>
<td>Comments on the impact of credit crisis on the proposed timing of convergence</td>
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<tr>
<td>Canada</td>
<td>2011</td>
<td>In Canada, the AcSB has been working very closely with the IASB. Canada is requiring ‘publicly accountable enterprises’ to report using IFRS effective for years beginning after 1 January 2011. There has been close cooperation with the IASB over the last several years, and work still continues on further convergence to the adoption date (Sycamore and Pfeiffer, 2009). The IFRS Advisory Committee (IAC) met in Toronto on 29 January 2009. The Chair and AcSB staff provided an update on recent activities of the IASB and the AcSB. The Chair noted that the Accounting Standards Oversight Council (AcSOC) and the AcSB have reconfirmed that nothing in the current economic environment has influenced them to change the date for Canada’s convergence as of 1 January 2011. In fact, some of the reasons for changing to IFRS, such as greater access to capital markets around the world for Canadian companies and strong investor support for a common set of accounting standards are even more apparent than before (IFRS Advisory Committee Report, January, 2009).</td>
</tr>
<tr>
<td>Korea</td>
<td>2011</td>
<td>Korea has decided that the best course of action is to simply adopt IFRS in its entirety. Previous attempts to adopt them and adopt them partially failed because investors did not believe the results were the same as IFRS (California CPA, June, 2008).</td>
</tr>
<tr>
<td>India</td>
<td>2011</td>
<td>The present financial crisis has thrown up a new set of problems of credit, job losses, decreased consumer spending and shrinking margins, and it comes as no surprise that the companies do not seem to be in a rush to implement IFRS. Regulators are also too occupied in grappling with new challenges to keep up the momentum. Moreover, the modification of Income-tax Act, Companies Act and other legislations that run counter to IFRS is not easy, and in practice, such legislative activity could take years. Therefore, Institute of Chartered Accountant of India (ICAI) and the Government have to play a larger role in addressing these problems to avoid long delays (Preet, 2009).</td>
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<tr>
<td>Brazil</td>
<td>2010</td>
<td>Brazil is on its way to converge with IFRS in 2010</td>
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<tr>
<td>Mexico</td>
<td>2012</td>
<td>Mexico is planning to converge by 2012</td>
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<tr>
<td>Argentina</td>
<td>2012</td>
<td>Argentina moves in the direction of convergence as planned</td>
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<tr>
<td>Malaysia</td>
<td>2013</td>
<td>Malaysia is firm with the plans to converge by 2012</td>
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</table>

AcSB, Accounting Standard Board; ASBJ, Accounting Standards Board of Japan; IFAC, International Federation of Accountants; IASB, International Accounting Standards Board; IFRS, International Financial Reporting Standards; GAAP, Generally Accepted Accounting Principle.
significantly accelerated their joint financial instruments and consolidation project and the projects on derecognition and impairment.

Overall, the analyses show that the financial crisis has made the case for accounting convergence more compelling. All the countries that have roadmaps to adopt IFRS are very confident that they will achieve their goal of accounting convergence.

6. Conclusion

This exploratory study highlights important implications of the global financial crisis for financial reporting, particularly identifying whether the trend towards convergence has been impeded by inherent problems in IFRS. Contrary to our expectations, analysis shows that the financial crisis has not impeded the trend towards accounting convergence: the majority of the countries intending to converge in the near future have not been affected by the global financial crisis and are committed to adopt IFRS as planned. Additionally, further progress towards convergence has also been achieved between IFRS and US GAAP.

The controversy surrounding the FVA and its impact on the global financial crisis has led to the levelling of a number of criticisms against the IASB, which has been taken to task for not being careful in providing enough guidance on the use of fair value rules. A number of recommendations for the IASB in improving the reporting requirements emerged from the financial crisis, and a comprehensive response by the IASB has been noticed. Some of the recommendations follow from the fact that pressures from the national bodies are inevitable, for example, the EU pressure to bring changes to IFRS 7 and IAS 39. These improvements in accounting standards, such as improvements in IFRS 1, IFRS 2, IFRS 7 and IAS 39, help to promote global financial stability and sound economic growth by enhancing transparency, reducing complexity and restoring confidence in the market. These improvements by IASB in IFRS have been made as a matter of urgency.

The reactions of countries planning to converge in the near future appear to suggest that the IASB’s approach in responding to the criticisms from the financial crisis has enhanced the reputation of IFRS and has increased their credibility. The findings of this study are important because they provide insights into how FVA brought on or deepened the crisis and how the regulators are going to rein in or define the use of FVA. The paper also highlights important implications for other countries that are planning to converge with IFRS but have expressed reservations owing to the current financial crisis.

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