

# The Role of Fair Value Standard in Global Financial Crisis

Dr.Osama Shaddad<sup>1</sup>, Dr.Nawwaf Al-Fawaerah<sup>2</sup>, Dr.Bader AlQaied<sup>3</sup>, Dr.Mustafa Alshokry<sup>4</sup>

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## Abstract

*The aim of the current paper is to evaluate the role of fair value accounting in the global crisis. There are two opinions related this issue: critics of fair value accounting argue that it triggered crisis depleting banks' regulatory capital while supporters of fair value accounting state that the role of fair value accounting in the pro-cyclical effects is insufficient. The number of works was analyzed to find arguments and counterarguments to defend or refute both opinions. Evidence is based on empirical research of the issue. There were two hypotheses tested to find the solution to the problem.*

**Keywords:** *fair value accounting, global crisis, regulatory capital, assets, banks, standards*

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## 1. Introduction

At the present time, fair value accounting (FVA) is widely promoted as international standards. However, the examinations of FVA standards can help reveal whether these standards can be used in the international context since FVA has certain advantages and disadvantages. Moreover, FVA was fiercely criticized by multiple scholars. Besides, FVA is sometimes considered to be responsible for subprime mortgage crisis that occurred in 2008. Fair value of assets is an estimated value of all assets and liabilities of a company based on rational estimation of the potential market

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<sup>1</sup>Assestant professor , Faculty Of Economic and Business , Jadara private University, Jordan. Email Address: [shaddad8@hotmail.com](mailto:shaddad8@hotmail.com)

<sup>2</sup>Assestant professor , Faculty Of Economic and Business , Jadara private University, Jordan

<sup>3</sup>Assestant professor , Faculty Of Business Administration , Ajloun National University, Jordan

<sup>4</sup>Assestant professor , Faculty Of Business Administration , Ajloun National University, Jordan

price of assets. Fair value accounting implies for reporting assets and liabilities on the balance sheets at fair value. It also involves recognizing gain and loss in the income statements. FVA is also called mark-to-market accounting on the condition that market prices determine fair value of assets. The research problem that will be considered in the current paper relates defense and criticism of FVA during the global financial crisis. The researchers that support FVA argued that FVA did not contributed to the worsening of the financial crisis while the critics stated that FVA exacerbated the severity of the global financial crisis that occurred in 2008.

The supporter of FVA argued that FVA improves economic efficiency because it speeds up recognition of inadequacy of the capital reserves to support lending. According to the point of view of the supporters of FVA, the banks shield themselves using FVA from the decline in market price because their assets are sound due to methods of accounting suggested by FVA. Thus, FVA cannot be alleged to cause decline in lending because it improves economic efficiency through forming adequate banks' capital reserves.

The critics of FVA alleged that FVA contributed to excessive leverage in the period of mortgage boom leading to excessive write-downs during economic busts. The write-downs caused by falling market prices contribute to depletion of banks' capital because the banks have to sell their assets at a significantly lower prices causing downward spiral in the economy.

The second argument against FVA relates pro-cyclical effects of FVA in the case of recognition of losses in fair value. Losses recognized in accord with FVA standards reflect exogenous fundamental shocks of assets prices forcing the banks to sell assets aiming to boost the capital ratio. Thus, being pressure to reduce prices, banks have to fulfill write-downs of assets to the level below of fundamental values. It results in unwarranted capital depletion and further price decrease.

The current research will make an attempt to critically evaluate the arguments for and against FVA making appropriate conclusion regarding consistency of this valuation method during the financial crisis. Besides, bottlenecks of International Accounting Standards (IAS) continuously discussed in the scholarly literature raise even more concerns than using FVA during the financial crisis questioning consistency of IAS. Taking into account the above mentioned, FVA will be examined from the following perspectives: consistency of FVA measurement standards, the correlation between fair value and future cash flows, reliability and operability of fair value standards.

## 2. Literature Review

Young, Miller and Flegm (2008) advocated fair value standard, but stated that it had to be improved. The authors argued that imperfections of the fair value standard, being surrounded by subprime-related financial instruments, contributed to the global financial crisis, but they were not the cause of this crisis. However, they hold the opinion that the accounting system had largely worked during the financial crisis.

Ramanna (2013) considered another side of the issue – the effect of the fair value standard on investment choices in comparison to historical cost valuation method. The author had adduced an argument that fair value accounting makes accounting information more relevant while historical cost accounting was considered more reliable.

In his article, Papa (2012) took a neutral standpoint considering the positions of both supporters and opponents of fair value accounting. Papa (2012) critically evaluated both views on fair value accounting stating that both views can exist. However, each method of valuation has certain disadvantages: fair value standard does not take into account fluctuations of the mortgage prices while historical valuation might be too conservative and does not reflect the real value of mortgage.

Jager (2014) focused his study on the links between fair value accounting (FVA) and the global financial crisis. The model used for the investigation of the issue showed that FVA acted as an accelerator that amplified the financial cycle upswing. Also, he revealed that the practices of not meeting rising credit demand with credit supply increased that were observed before crisis acted as a control mechanism.

LaCalamito (2013) made an attempt to analyze the causes of the global financial crisis considering the reliability and transparency of FVA. He paid particular attention to the role of Statement of financial Accounting Standards (SFAS) No.157 in times of market turmoil. The author analyzed a number of scholarly works that related the role of accounting standards during the crisis.

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Courtois(2010) pointed out that valuation is the most profound aspect of corporate finance. The author considered that the financial crisis posed significant challenges to valuation. FVA was described as the major concern during the financial crisis. The author concluded that valuation methods should be significantly improved by taking into account extreme risks.

Zhou adding (2009) discussed the issues related FVA aspects from three different perspectives: the meaning of fair value, the impact of fair value, and applicability of fair value in different countries. Zhou and Ding (2009) stated that some of the elements of fair value contain inaccuracies that inevitably led to the inaccurate measurement. The authors considered FVA in Chinese settings.

Scott (2010) stated that FVA caused volatility in the financial markets by forcing the companies to impair their regulatory capital as they recognized all losses at a time. The conclusions of the

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Gallacher and Luthy (2009) examined the issues of the causes of the financial crisis and outline the possible cause of the crisis. The author held the point that the financial crisis did not occur as a result of reporting all losses at a time. Accounting for impairments was the major concern of using FVA standards. The authors also stated that FVA standards applied to inaction markets should include examination of illiquidity.

### **3. Research Methodology**

The current research is based on the results of the secondary research conducted by several authors that considered the problem of FVA. There will be two hypotheses raised in the course of the current research:

- H1 – FVA standards helped creating the global financial crisis;
- H2 – FVA standards helped revealing the global financial crisis.

The hypotheses testing will be based on the opinions presented in the studies that are examined. The meta-analysis method will be used for the purposes of the current research. The purpose of meta-analysis is to analyze the results of a number of empirical studies statistically. Meta-analysis creates a need for consistency and precision in defining the quantity of the empirical findings. Also, the variables should be properly coded. There were sixteen empirical studies examined. Also, the studies that were based on the analysis of the empirical studies were also included.

The studies were included into the meta-analysis according to the following criteria: the studies include the analysis of FVA measures, the studies include a sample of banks analyzed or based on the empirical research, and contain the judgment related one of two hypotheses. FVA measures analyzed in the studies will help assess the underlying definition of FVA standards. The analysis of the banks' sample will help assess the reliability and relevance of the research. The availability of one of the two hypotheses will help conclude regarding the argument that was raised by the researchers. Further, the number of supporting and refuting arguments towards FVA will be evaluated and the appropriate conclusions are made.

The studies for analysis were selected by scholarly features because only scholarly literature provides reliability and relevance to the studies. Studies were found with the help of internet search tools such as Google.com. All of the studies were examined using academic criteria: they were published in the academic journals, the authors have academic degree in Economics or Finance, the research methods for statistical analysis are widely used and well-known, and the studies were based on the theories derived from appropriate academic sources.

The results of the research will be divided into two parts: the studies supporting FVA and the studies refuting FVA as reliable tool for valuation. The number of studies will be calculated with appropriate conclusions related relevance of using FVA standards drawn. Also, the limitations of the researchers will be examined because they can significantly influence the results of the current research. The limitations will be carefully analyzed and the results of the current research will be corrected according to the limitations revealed.

There are relatively few studies that empirically examine the role of FVA in the global financial crisis. Therefore, complementary studies contributing to the current research will be also examined. The complementary studies are supposed to add understanding of the problem.

The main requirement to the complementary studies is that they contain certain opinion related the role of FVA in the crisis. The results of the evaluation of the main studies will be examined and supplemented by the results of the complementary research.

#### **4. Findings**

Young, Miller and Flegm (2008) advocated fair value standard, but stated that it had to be improved. The authors argued that imperfections of the fair value standard, being surrounded by subprime-related financial instruments, contributed to the global financial crisis, but they were not the cause of this crisis. However, they hold the opinion that the accounting system had largely worked during the financial crisis.

Ramanna (2013) considered another side of the issue – the effect of the fair value standard on investment choices in comparison to historical cost valuation method. The author had adduced an argument that fair value accounting makes accounting information more relevant while historical cost accounting was considered more reliable.

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Laux and Leuz (2010) assessed the arguments for and against FVA in its role in the financial crisis based on the results of empirical research. The analysis showed that FVA standards contributed to the development of the global financial crisis. They authors also found little support for the argument that FVA led to excessive write-downs of banking assets.

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Courtois (2010) pointed out that valuation is the most profound aspect of corporate finance. The author considered that the financial crisis posed significant challenges to valuation. FVA was described as the major concern during the financial crisis. The author concluded that valuation methods should be significantly improved by taking into account extreme risks.

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Scott (2010) stated that FVA caused volatility in the financial markets by forcing the companies to impair their regulatory capital as they recognized all losses at a time. The conclusions of the author are based on the analysis of the current literature to the point. Also, the author examined another point of view supporting the idea that FVA did not contribute to the aggravation of the financial crisis.

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