EUROPEAN COMMISSION GREEN PAPER: LONG-TERM INVESTMENTS

Comments from the French Accounting Standards Authority (ANC)

"THINK LONG-TERM FIRST"

The Green Paper focuses on a crucial issue: what are the causes of the misalignment between finance and the economy? Why are financial markets so deep yet businesses cannot get funding? What exactly are the effects of the rules governing the workings of the markets and the economy?

I – As the financial sphere expands, huge amounts of liquidity are seeking immediate profits

- In the past thirty years, the financial markets have grown to unprecedented proportions. Market players are seeking higher rates of return than what the real economy can offer.

- The "crux" of the matter, the common denominator of the markets' increasingly preferred approach, consists in reducing economic phenomena to a short—even instant—time horizon. This short-termist view is detached from all economic reality—or, rather, it creates a new, purely financial reality. The countless examples we could mention include complex products (promising ostensibly calculated but actually hypothetical returns), bonuses (based on profit calculated and booked before it is made), and algorithmic trading.

- The standards developed for controlling these market activities—especially since the financial crisis—aim to minimise the risks to institutions, products, markets, and taxpayers. Specific, complex regulatory instruments have been deployed. While all these measures ultimately aim to ensure the financing of the economy, it is not always easy to combine this goal effectively with an immediate impact on market operations—all the more so as markets are constantly introducing new operating procedures.

- It would be wrong, however, to conclude that "financialisation" has become a universal phenomenon. Banks and insurers still play a major role in the real economy, particularly in France. But strictly financial activities represent a steadily growing mass of liquidity far greater than the real economy.

- The Green Paper's entire purpose is to identify the impact of these rules on financial markets. Do they encourage purely financial activities or do they channel them towards the financing of the real economy?

II – The rules applied to the financial sphere can have undesirable consequences on the real economy

- Accounting rules should be examined first, as they are supposed to describe economic reality for all players, especially lawmakers and standard-setters. If the rules cause distortions, they will affect all regulatory and economic decisions.

- It is often stated that the IFRS were originally designed to combat a certain form of financial laxity by obliging financial institutions to face the future consequences of their risk-taking immediately. But if all future consequences of a transaction can and even should be recognised immediately in the accounts, this creates an infinite opportunity for the financial sphere to anticipate profit-taking.

While asset bubbles always develop autonomously, they could not flourish without this short-termist environment. The latter includes the rules introduced in the early 1990s, which broke with the market stability that had prevailed since the 1929 crisis.

- As a result, financial statements are increasingly the result of calculations. Because these calculations measure products or concepts that do not exist (at least for now), they rely mainly on market prices, which determine book values. In other words, accounts now reflect market trends far more than the performance of the entity whose financial statements are being examined. Value changes are increasingly theoretical and often volatile, making financial results less easy to understand.

- This approach is theorised by the term "fair value" on the grounds that the market is the ultimate means of determining a fair assessment. This ignores (1) the extent to which the markets, when totally uncontrolled, can be inefficient or even unreliable (e.g. LIBOR), and (2) the fact that when assets are held without changing hands, or when no trades occur in inactive markets, "fair value" is a term that conceals a mere reference to models that have nothing "fair" about them.

- The 2007-2008 crisis was the result of this environment. It began with a bubble that was made invisible, since all values were moving in step, in the markets and in the accounts, which became meaningless. Then came the collapse, which was lagged, then amplified—two phenomena that the G20 was characterising as "procyclical" by 2009.

- These phenomena extend far beyond financial instruments alone and the sole application of "fair value". In reality, it is the entire set of accounting methods that consist in measuring *future*, unrealised transactions *today* that produce the same *accounting bias*. By representing the future in the accounts, one thing is certain: the accounts are not "prudent".

- The problem is that the IFRS approach is centred precisely on the primacy of the balance sheet over the income statement—in other words, the primacy of the instant "snapshot" over the time frame of the real economy, which needs to be long enough to generate the flows that produce the profits.

- The elimination of the cardinal principle of accounting—prudence—is a totally deliberate choice by the international standard-setter, the IASB, and has crucial implications. But the same approach informs other standards, in accounting and elsewhere, once the short term has been chosen as the time frame. This is exactly the case with the Solvency II standards, which have adopted a one-year horizon to assess risk in the economic sector that, by logic, should be the most strongly focused on the long term.

- The consequences on the real economy are immediate. Financiers cannot take long-term risks if they give negative marks to performance assessed on short-term criteria in keeping with biased standards.

III – A better balance can be restored by going back to basic principles

- Principles for avoiding short-term bias have existed since the origin of accounting, of which they form the backbone. They consist in: recognising only transactions that are certain; circumbscribing the recognition of risk-taking, based on judgement by the firm, in depreciation and provisions; distinguishing explanatory information from the accounts themselves, which, to be fair and true, cannot include unrealised transactions; and restoring the concept of prudence, which, in its strict sense, is asymmetrical and entails the recognition of losses, not profits.

- This implies giving precedence to the search for intrinsic, basic, economic values—in other words, complying with the request voiced by the G20 in London in 2009 to take the investor's "time horizon" into account. This requires us to concentrate on the actual time taken to accumulate cash-flow, a process we can call the "business model".

- We can therefore see that the quest for balance between the short term and the long term is hardly just a matter of taking a stance "for or against fair value". On the contrary, it requires the following: booking at market value the transactions that are effectively carried out by the firm on the market; rejecting market value for operations that do not take place in the short term; sincerely addressing the question of the treatment of illiquid assets, which have no market reference (the question has been ignored since the crisis, in spite of its having triggered the event).

- Such a return to equilibrium—between short and long term, between balance sheet and income statement—requires: a change in the "conceptual framework" of the IASB (and FASB) that goes beyond cosmetic changes, such as the possible reintroduction of the term "prudence"; the consequent change in certain existing standards or draft standards, such as IFRS 9 on financial instruments; simpler wording of standards, closer to reality and less abstract; consequently, an IASB governance less focused on a "supply" of standards that still bears the stamp of obsolete ideologies, so as to take better account of "demand" from all parties—starting with the European citizens who seek a long-term framework conducive to growth and employment.

- Ever since the crisis began, the ANC has championed—on technical and strategic grounds—all the measures set forth above. The Green Paper offers the opportunity to suggest that the restoration of a balanced approach should become a priority. Even though the purpose is not to create a long-term bias but to eliminate a short-term bias, a good slogan would be "THINK LONG-TERM FIRST", to paraphrase a European expression. In the absence of such rebalancing at international level, the European Union will have to draw the consequences from this.