Financial reporting and financial stability: causes and effects

It is sometimes claimed that financial reporting was a significant cause of the recent financial crisis or that it made the crisis significantly worse than it needed to be. Such claims are not new – mark-to-market accounting was identified at the time as a contributory cause of the Great Depression in the 1930s. But what is the evidence for these claims? In any case, should such questions be relevant to decisions on financial reporting standards? And how do financial crises affect the evolution of financial reporting? These issues were discussed by a team of distinguished academics in a panel session at the American Accounting Association (AAA) annual meeting in Denver on 10 August 2011.

The panel comprised:
- Mary Barth, Joan E Horngren Professor of Accounting at Stanford Graduate School of Business
- Robert Hodgkinson (Moderator), Executive Director, Technical at ICAEW
- Shyam Sunder, James L Frank Professor of Accounting, Economics and Finance at Yale School of Management
- Gregory Waymire, Asa Griggs Candler Professor of Accounting at the Goizueta Business School, Emory University.

Gregory Waymire suggested that there are three stages of financial crises that have to be analysed:
- the pre-crisis period, when rising asset prices create a bubble;
- the crisis itself, when asset prices fall; and
- the post-crisis period, when people try to understand what happened and make changes to try to stop it happening again.

For the period before the crisis, the question is: would better accounting have prevented the bubble? The evidence suggests that accounting is not a primary driver of asset bubbles. It is very plausible, though, that it might have an amplifying effect; the best evidence for this comes from experimental work, but overall the evidence – experimental and archival – is weak and complicated.

The question for the period during the crisis itself is: is there a causal relationship at the firm level between the crisis and accounting evolution? Accounting evolution during a crisis can take place in three ways:
- by the elimination of weaker firms during the crisis (natural selection);
- by transformation of accounting practices during the crisis, eg, by weaker firms mimicking more successful firms’ practices; and
- by a migration effect as new firms that emerge after the crisis adopt new accounting practices.

At the level of particular accounting policies, it seems unlikely that the effects of policy choices are so significant that they will have an effect on a firm’s chances of survival. So any accounting evolution during a crisis is more likely to be through transformation and migration effects.

After the crisis, when accounting reforms are introduced to prevent it happening again, there is a risk that the cure will be worse than the disease. The problem is that there are complex interactive effects of such changes, which are very likely to have unintended consequences. So it is doubtful whether reforms will make things better.
Standard setters need to strive for the right balance in imposing controls; if you impose too much control, you drive people away. So we need to understand people and then create the conditions for more favourable behaviour. This does not mean imposing one standard for everyone everywhere. We need robust rules that are shown by experience to be effective – they won’t be produced by a conceptual framework.

Accountants are usually blamed when there is a crisis – they are ‘the usual suspects’. Accounting systems certainly affect human behaviour, but we don’t know a lot about how they do so. Overall, we understand very little about the relationship between accounting and financial crises, so the good news for researchers is that opportunities abound for ignorance reduction.

Mary Barth said that standard setters and regulators appear to have different objectives. Standard setters are primarily interested in transparency, regulators in financial stability. So regulators may want firms, in the good times, to build up cushions against bad times or, in times of crisis, to make the crisis appear not to be there. This is likely to conflict with transparent financial reporting. But standard setters and regulators do have some interests in common; they both want to use financial reporting information to help understand economic reality.

The evidence does not suggest that fair value accounting either caused the recent crisis or made it significantly worse. Fair value just reflected falling asset prices; it didn’t cause them. In any case, falling asset values during the crisis were an issue for historical cost accounting as well – firms reported huge historical cost impairments.

There have been suggestions that reported falls in asset values triggered asset sales to meet regulatory requirements. But regulatory requirements are up to regulators; if they think asset sales are undesirable, they can adjust their requirements accordingly. Also, some of the filters that regulators apply to financial reporting information are procyclical: eg, not recognising gains on the falling value of a firm’s own liabilities.

However, financial reporting did not do a good job ahead of the crisis in reporting on risk. There was hidden leverage and hidden risk. There should have been more transparency.

Shyam Sunder commented first on the relationship between financial reporting and financial engineering, and then on government accounting.

For over seven decades we have worked on the assumption that writing accounting standards improves financial reporting, ignoring financial engineers who make a living out of finding ways around the written accounting standards. It may take them less than three hours to find a way around a standard that may have taken three years for standard setters to prepare. Standards affect only those who are willing to comply with them. This interplay between financial reporting and financial engineering was a fundamental issue in the creation of the financial crisis. For example, much of the securitisation of sub-prime mortgages was motivated by desire to get debt off the balance sheet.

We can think of accounting in two quite different ways. One is as a satellite camera – which quietly photographs from a great distance and has no discernible effect on the images it records. The second is as a photographer paired with a model, where the model smiles and poses for the camera. We may want accounting to be like a satellite camera but it has a reflexive relationship with what it records.
There is a large gap between what standard setters can achieve and what they are expected to achieve. Social systems are so complex that it’s unrealistic to expect anyone to have the knowledge and ability to design a better system. We need a better balance between the top-down imposition of standards and bottom-up evolution of accounting practice, and between dependence on rules and dependence on judgement. Over the past 70-plus years we have moved from almost total dependence on judgement to almost total dependence on written rules. The British idea of a ‘true and fair’ override would help improve financial reporting.

As the crisis has moved on from banks to governments, it is worth thinking about government accounting. Just as it is difficult to stop corporate CFOs from manipulating earnings, civil servants have little power to refuse to manipulate government accounts if they are told to by the politicians. Disciplining sovereign states for poor accounting – think of Greece and its problems – is a major challenge for accounting, and it seems to be a largely unaddressed aspect of the current financial crisis.

Mary Barth agreed that accounting rules have invited financial engineering. We need to avoid bright-line rules, and have tougher principles instead. We also need to get away from having tens of thousands of pages of rules (often written at accountants’ request) if accounting is to become more of a profession again; accountants need to make judgements and to accept responsibility for them. IFRS does have a true and fair override: the ‘present fairly’ requirement. But research on the true and fair override in the UK shows that it was used to manage the numbers rather than to improve transparency.

The panel session was attended by about 1000 conference delegates, and there were a number of comments and questions from the audience. Responses to some of these are included in the summary above. Questions and comments included:

- The people who design financial instruments often base them on accounting standards – and they like the standards to change so that they can design new products.
- The crisis shows that we need to change the accounting system. Basing it on liquidation values would be an improvement.
- Accountants may be back in politicians’ gunsights in the next crisis. What can we do now to avoid this?
- In the run-up to the crisis, disclosure was treated as an alternative to regulation.
- If standard setters cannot influence behaviour to achieve the results that they wish, they can at least avoid writing bad standards.

The session was sponsored by the AAA Financial Reporting and Accounting Section and organised by ICAEW.

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