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Held to account

Accounting is about more than numbers – getting it right goes to the very core of corporate governance, and getting it wrong can have disastrous results. Shyam Sunder explains.

Corporate governance is closely intertwined with various aspects of accounting – financial reporting, managerial control, compensation, internal and external audits, and taxation. It is often difficult to isolate governance from control, and fascinating to explore their interactions.

Financial reporting was indeed a root cause of the global financial crisis for two reasons. First, specific financial reporting standards such as mark-to-market valuation in the comforting guise of 'fair values', and delay in recognition of bad debts until loss is incurred, helped distort information and investment decisions and contributed to market failures. The role of financial reporting is to provide information for the markets so investors can independently value the securities, and not merely prepare financial reports from the market price of the securities.

Second, excessive dependence on written standards to the exclusion of 'true and fair' overrides based on global judgment created a spiral of interplay between financial reporting and financial engineering. This spiral ensured that the intents of any written financial standards could be defeated by financial engineers through the redesign of instruments, transactions, and organisations. This spiral fed the crisis, and contributed to the magnitude of its consequences.

The accounting and business community accepting greater responsibility for fairness of financial reports may help improve this situation. However, there are good reasons for scepticism. We should not hold our breath for significant improvement in spite of all the promises of reforms in the US and the rest of the world. Just as a good democracy requires vigilant and responsible citizens, good corporate governance also is not possible without vigilant and responsible investors.

Pro-cyclicity of mark-to-market

The pro-cyclic amplification of the business cycle promoted by mark-to-market accounting is the best known argument in favour of proving accounting was a root cause of the global financial crisis.

Most of the people who resisted the pro-cyclicity argument against mark-to-market accounting when we first made it early 2007 have now come around to recognise this problem. Lord Adair Turner, the chair of the UK Financial Services Authority, summarised it well in his January 2010 address to the Institute of Chartered Accountants in London:

'When credit is extended in a securitised form, with the market price of credit clearly visible from trading in credit securities, there is an inherent risk that credit supply and pricing can be subject to self-reinforcing herd effects, with originators of and investors in credit treating the market level of credit and credit default swap spreads as indicators of credit risk and thus of appropriate credit pricing. In the upswing this feeds the rising price of credit securities, falling spreads, increased origination, and a self-reinforcing willingness to invest in credit securities or indeed to lend on balance sheet.'

In addition to the pro-cyclical consequences of mark-to-market accounting for trading books, we should consider the pro-cyclical consequences of the current accounting rules for recognition of loan losses. Since these losses are recognised only when they are incurred, and not on an expected value basis, a downturn in the business cycle brings recognition of large loan losses, lowering bank income as well as capital, which in turn lowers the availability of credit, further reinforcing the economic downturn. The reverse happens in economic upturns.

However, beyond these well-known arguments for pro-cyclical effects of

current accounting rules is a larger structural problem of accounting rules that has received little attention in regulatory, governance or academic circles.

The structure of financial reporting rules and institutions

The presumed objective of financial reporting is to help make various decisions, and define and implement contracts through specification of constraints on contracting parties.

Since the introduction of federal securities laws in the US some 80 years ago, regulators and accountants have sought to achieve this end by moving away from what had originally been a common law construct called generally accepted accounting principles (GAAP). During these 80 years, there has been a progressive shift towards a quasi-statutory regime of formal written standards issued with the enforcement power of regulatory authorities. Under the US Financial Accounting Standards Board and the International Accounting Standards Board this process of transforming GAAP to a top-down prescription is almost complete; it no longer emerges bottom-up as a social norm of business practice.

This gradual but radical shift from broad scope for professional judgment to progressive 'clarification of rules' and 'guidance' has been popular not only with the regulators and accountants but is also demanded by many in the business and financial communities. What, one might ask, is the source of complexity, and what is wrong with having clear written rules to deal with it?

The elephant in the room: financial engineering

The reason is the accountants are not the only players in the arena of financial reporting; they have the formidable and adversarial company of financial engineers.

Financial engineering consists of the design, analysis, and construction of financial instruments, transactions and organisations to meet the needs of the enterprise. These 'needs' consist of goals like reducing indebtedness on the balance sheet and expense on the income statement, increasing revenue on the income statement, deductions on tax returns, and regulatory capital on the bank balance sheet. Financial reporting and engineering have diametrically opposed goals.

Financial reporting has no chance of winning this unequal battle. It may take a few years for the FASB or IASB to make its policy in form of a rule on an accounting issue (unless it is under pressure from the US Congress or a Gallic politician, in which case years are compressed into days). It takes mere hours or days for the financial engineer to circumvent the new accounting rules intended to put constraints on managers. While accountants are limited to doing the accounting for transactions chosen by the managers, the latter are free to devise the transactions, instruments, and even organisations (recall Enron's 3,000 special purpose entities) to circumvent the intent of the financial accounting rules. The history of leases and various kinds of financial derivatives and securitisation provides a wealth of evidence.

Financial engineering is the elephant in the room of financial reporting that nobody is willing to admit is present. Yet financial engineering has played a critical role not only in defeating the intent of financial accounting rules, but also pushing the rules towards increasing detail in fruitless attempts to plug the holes. Ironically, the more specific the rules get, the easier is the job of the financial engineer: specificity reduces uncertainty about violating the rules.

The current structure, which relies on top-down financial reporting standards, falls into this trap. It replaces accountant's judgement by increasing detail under the guise of 'clarification' or 'guidance'. Even IASB's so-called principles now cover some 3,000 pages – something unheard of in other learned professions where judgment dominates written rules.

What can we do?

Use effective yield rate to estimate loan loss reserves

I have two suggestions for dealing with these problems. On pro-cyclicity with respect to loan loss accounting on bank books, accountants can use the information on default risk associated with individual loans contained in the yield rate on the loans themselves since this yield is negotiated in an arms-length transaction.

For example, if a loan has a yield of 8% at a time when the risk-free rate on loans of comparable term is 5%, the difference of 3% is a reasonable estimate of the default risk. This estimated default risk can and should be used to recognise expected loan losses at the time of issue and subsequently. This process will make sure that the loan loss reserve is set up to match the magnitude of risk the bank has taken in giving the loan to a client. This is not a device to artificially smooth the income over multiple cycles, as some have suggested.

Balancing statutory and common law approaches in financial reporting

On the structural problems, we could seek a middle ground. Just as lawyers balance these two approaches without getting trapped in either end, financial reporting also could benefit from striving for a better balance. Unfortunately, regulatory monopolies granted to national or international boards in most jurisdictions can hardly be expected to strive for such a balance. Limited supervised competition among two or more standard setters might do better. In spite of frequent arguments about the race to the bottom in such a competition, there is plenty of evidence from various domains (state charters of corporations, universities, environment, etc.) that this fear is misplaced.

In a competitive mode, standard setters may rediscover that evolution with trial-and-error experimentation, and 'true and fair' override of rules based on judgement will limit complexity, improve financial reporting and help it withstand the incessant pressure of financial engineering. The mantra of a single set of high quality principles-based accounting standards for comparability across the whole world has been repeated often. Yet, even accountants deny that the application of IFRS across member countries of the European Union is uniform.

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