Accounting Antecedents of the Global Financial Crisis

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Since the introduction of federal securities regulation in the 1930s, financial reporting in the U.S., and arguably in the rest of the world, has become increasingly dependent on written rules. These rules, under the label of financial reporting "standards" in various jurisdictions around the world have grown rapidly to thousands of pages, and largely replaced social norms and professional judgment of managers and accountants. However, the connotation of quality of the financial reports implied by the label "standards" is misleading. On the contrary, written standards are susceptible to gaming by financial engineers equipped with mathematical techniques, and have proved to be quite ineffective, even self-defeating. This transformation of financial reporting constitutes an important accounting antecedent of the financial crisis in the U.S. and Europe.

Beginning with the Markowitz' introduction in portfolio theory in 1952, dispersion-of-outcomes as a measure of risk has progressively dominated the traditional concept of risk as the possibility of harm, injury or loss. The latter concept of tail risk, dominant in sports, medicine, engineering, insurance, credit, and regulation constituted the foundation of prudence and conservatism in financial reporting. Acceptance of the dispersion (or variance) measure has led the accounting rule-makers to drop conservatism in favor of unbiasedness as a desirable characteristic of financial reports.

Setting aside prudence, and worshipping at the altar of liquidity, accounting rule makers discarded the lower-of-cost-or market basis of financial reporting in favor of market values (under another rhetorical trick of a misleading label "fair value" accounting), rendering financial reports more vulnerable to financial engineering of securitization. Mark-to-market criteria replaced accounting *for* the markets by accounting *from* the markets, making the financial system vulnerable to pro-cyclicity. It encouraged issuers of derivative securities, designed to bypass the written accounting rules, to control the liquidity of their markets.

Unfortunately, little has been done to date to remove these accounting antecedents of the crisis. Revisiting the value of social norms and professional judgment, and strict specification of limits on what banks with access of public money and guaranties are permitted to do, may be necessary to prevent repetitions in the future. Good accounting and finance, like good plumbing and electrical wiring, are boring and low-paid occupations. In history, high compensation, excitement, creativity and innovation in accounting and finance have served as harbingers of crises. As Boeing discovered recently, good batteries just work without making smoke or news.