Did Accountants Really Let Us Down? Floyd Norris Misfires on FASB & IASB Role in Recession

by Kurt Schulzke on September 11, 2009

Who ruined your retirement portfolio? In his September 10, 2009 New York Times' column, Accountants Misled Us Into Crisis , Floyd Norris points the finger at standard-setting accountants at the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).

Norris appears convinced that if the FASB and IASB had written the "right" accounting standards the "right" way (especially to require banks to report their assets at "fair" value), banks could not have become so weak as to threaten the financial system. If only reality were that simple. Four factors argue against Norris' view.

First, demands by market analysts and others for "fair value" financial statements are misplaced. The reality of today's internet-fueled markets is that no asset or group of assets has a single "fair value" that lasts for more than an instant. Verifiable market values, if they exist at all, often move dramatically in mere minutes or hours. No profession — not accountants, actuaries, analysts, physicists or attorneys — can pinpoint a single, verifiable "fair value" for any financial asset. One notorious illustration occurred only a year ago.

Fleeing from a run on Wachovia Bank, the U.S. government tried to force Wachovia to sell itself to Citigroup. On the night of October 2, 2008, the country turned out the lights "knowing" that Wachovia's "fair value," as established by the terms of the Citigroup sale, was $2.16 billion. The next morning, October 3, we awoke to the news that the Wachovia''s "fair value" had miraculously increased overnight to $15.1 billion, thanks to a bid by Wells Fargo.

Can anyone claim, today, nearly a year after the event, that they *unequivocally know* Wachovia's "fair value" at the close of business on October 2, 2008? The same uncertainty afflicts asset values across the market — commodities, stocks, bonds, mortgage-backed securities, used cars — you name it. The most we can say about any asset's value at any moment in time is that it falls with less than 100% reliability within some range of values. It is fundamentally misleading to claim as "fair" any particular number within that range. To demand that accountants lie to readers by reassuring them of the existence of a non-existent number is manifestly unfair. Perhaps accounting rules should require less precision (which some erroneously equate to "transparency") in valuing assets rather than more.

Second, the idea that banks would be more healthy if forced to be more transparent flies in the face of banking reality. Our fractional banking system — as vividly illustrated by Wachovia's near death experience last fall — is at its core a con game. The more light you shine on it, the faster it goes out of business. Not for nothing is the Federal Reserve fighting desperately to avoid disclosing banks' discount-window transactions to Bloomberg News.

A bank's survival depends on its ability to persuade (snooker?) the vast majority of depositors into believing that they can get their money out at any time when every banker knows that no more than 10 percent of deposits (and often significantly less) are actually held by the bank. Thus, banks rely in part of lack of transparency just to survive. One might argue that the more transparent a bank's financial statements, the faster it will go out of business. The FASB and IASB can hardly be faulted for declining to write accounting standards that would push most banks over the edge.

Third, public companies — including banks that are publicly traded — are *already required* by existing IFRS and SEC rules to provide what Norris demands and more. Under both sets of rules, publicly traded banks must report all material information to the market in their financial statements or other required disclosure documents.

Under the "true and fair override" of IAS 1, para. 18, if a set of financial statements prepared in accordance with detailed IFRS standards are nevertheless misleading, then an IFRS-compliant company must change the financials (in violation of the detailed rules) to ensure as much as possible that they fairly state the company's position and results. Norris and I last debated true and fair view, in 2008, in the context of another bank-accounting controversy, Societe Generale's "report everything in 2007″ approach to Jerome Kerviel's trading losses.

The SEC (though not the FASB) has a similar rule, SEC Rule 12b-20. This rule requires that companies provide whatever additional disclosure is necessary to make misleading-yet-FASB-compliant financial statements not misleading. Rule 12b-20 has been on the books since 1965. Its consistent application by the SEC would make unnecessary any changes to existing financial accounting standards. Hence, to the extent that financial reporting really had anything to do with the mess, and it's not entirely clear that it did, it is hardly fair to pin the blame on either FASB or IASB.

Fourth, investors, analysts and institutions simply must accept some responsibility for their own decisions. If you do not understand what you are reading in a set of financials — say, for example, that you just cannot parse the economics of those darned CDOs or mortgage-backed securities — then don't buy the stock. How hard is that?

Some of Bernie Madoff's victims knew that he had to be doing something illegal but they invested anyway because they liked his "returns." In the broader market, a fair share of institutional investors were burned by investing in companies or products, like mortgage-backed securities, whose financial disclosures they knew they did not understand. Investors who are so cavalier with their funds should be full responsibility for their losses.

Now a few comments focused on specific portions of Norris' piece:

> It is unfortunate that there are significant differences between the American and international rules on how to determine fair values of financial assets. That has enabled banks on both sides of the Atlantic to demand that they get the best of both worlds. Pleas for a level playing field have resonated in Washington and Brussels.

I'm not sure what to make of this paragraph. Why are "significant differences" between the two sets of standards so unfortunate? Isn't the opposite possibly true, that the market is fortunate to have two different sets of standards running in parallel in such a way that comparative strengths and weaknesses are more clearly evident?

> The banks have argued that market values can be misleading, and that their own estimates of the eventual cash flow from assets are more realistic than what they — or others — will now pay for those assets. The rules already allowed them to ignore so called "distress sales" in assessing fair value, but the banks pushed to broaden that exemption in the United States, while in Europe they got the regulators to allow them to retroactively stop calculating market value for assets they said they did not intend to sell.

Is Norris arguing that "market" values cannot be misleading? What about that October 2, 2008 value of Wachovia Bank? As any trained business valuation specialist will attest, the value of an asset absolutely depends on *when* the seller intends to sell and to *whom*, hence the notion of "control premiums" and "minority discounts."

> Behind the scenes, there is a battle pitting securities regulators — who instinctively favor disclosure — against banking regulators, who fear there are times when disclosure could make a bad situation worse.

I'm not convinced that securities regulators "instinctively favor disclosure," but there's no doubt that more transparent disclosure could undermine the con that we accept in our banking system.

> The securities regulators argue that accounting should do its best to report the actual financial condition of a company. If the banking regulators want to allow banks to use different rules in calculating capital — rules that would not require marking down assets, for example — then they can do so without depriving investors of important information.
>
> But that information could scare those investors, and set off the kind of panic that brought down Lehman Brothers a year ago.

While I agree that banking regulators should be able to look past the FASB rules in determining how to address capital adequacy, securities regulators, analysts and pundits need to quit pretending that the "actual financial condition" of a bank can be measured with scientific precision. The collapse of Long Term Capital Management should have taught market watchers that the laws of physics (themselves imprecise) do not apply to financial markets. Hence, we should always think in terms of a range of values, not a single verifiable number. To insist that bank financials conform to an arbitrary standard that produces a single "right" result is as counterproductive as producing no number at all.

> It is the job of banking regulators to keep their institutions healthy, and that effort can only be helped by accounting that reveals problems early. . . .

Again, I'm not convinced that early public "revelation" of these kinds of problems will help keep banks healthy. Perhaps the threat of such disclosure would force banks to behave more conservatively in the first place. It's hard to say.

> The accounting rules on financial assets were, and are, a confusing mess, with the same loan getting very different accounting based on whether or not it had been packaged as part of a security. . . in the crucial area of fair value accounting, the American and international boards are not moving in tandem. The international board is delaying some issues as it rushes to get a rule out this year that will clarify when banks can ignore fair value. The American group is taking a more unified, and slower, approach. By not moving together, they run the risk of a race to the bottom, with investors the losers.

While I agree that financial assets accounting is confusing, where is the support for the assertion that FASB and IASB "not moving together" risks "a race to the bottom"? I see the opposite: A contest between two competing regulatory systems each of which is striving to demonstrate its superiority over the other. Having two competitors is good for the market, not bad.

> The fights over bank accounting are taking place against the backdrop of the S.E.C. trying to decide whether and when to move the United States to international accounting standards, and as the two boards seek to converge on one set of accounting rules.
>
> Mr. Ciesielski fears convergence could lead to acceptance of the weakest standards for banks. But without convergence, the S.E.C. will have no standing to oversee application of international standards, or to act as a counterweight if European politicians try to order even weaker standards to protect their banks.

Why the absence of accounting standards convergence would result in the SEC having "no standing to oversee application of international standards" or to "act as a counterweight" to EU politics is a mystery. The SEC has jurisdiction to oversee application of IFRS standards to all companies whose shares are publicly traded here in the United States. No one that I know of is suggesting that the SEC cede its enforcement powers to the EU. Is Norris looking for some more expansive, extraterritorial power?

The bottom line is that too many people are expecting far too much precision out of financial statements that were never intended to convey a continuously-updated view of a company's fair value. At best, the financials can provide a broad, momentary glimpse of the company's near-reality in the context of the "going concern" assumption. Holding accountants or their standards responsible for more than this is unfair and foolish. If anything, in this instance, financial statement readers let themselves and the accountants down, not — as Floyd Norris suggests — the other way around.

Tagged as: fasb, IASB, international accounting standards, rule 12b-20, true and fair view

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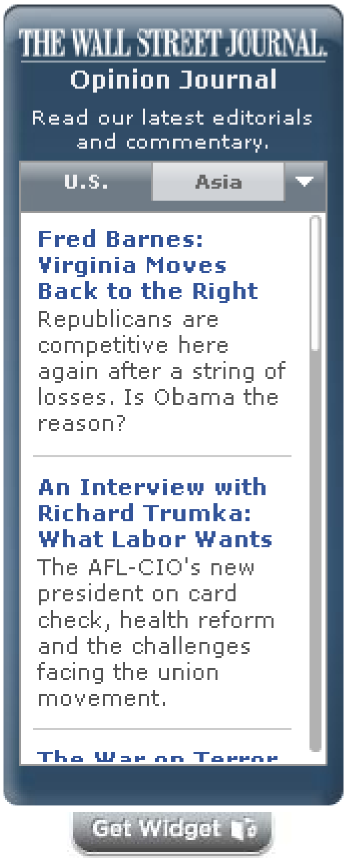
- 

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