CONSIDERATIONS ON THE ROLE OF ACCOUNTING RULES IN THE CURRENT FINANCIAL CRISIS

CONSIDERAȚII PRIVIND ROLUL CONTABILITĂȚII ÎN CRIZA FINANCIARĂ ACTUALĂ

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Abstract: *The current financial crisis has started on the US subprime mortgage market in the summer of 2007, reaching unexpected levels by 2008, rapidly spreading all over the world and disrupting the global financial system. The losses sustained by the American financial giants on complex structured securities triggered the collapse of other markets such as the housing market or the auto market. In less than a year, the balance-sheets of the biggest financial companies reported impaired assets and major declines in value due to the lack of liquidity of certain markets or assets. The investors' confidence in the financial markets and institutions has reached a new historical low and the financial crisis has triggered the economic crisis. This context has lead to strong debates among bankers, insurers, auditors and politicians about who is to blame for the crisis, but also about finding the solutions for surpassing the crisis and reducing the likelihood that this situation would recur. The paper aims at determining the role of accounting rules in causing and spreading the crisis, at assessing the recommendations and resources developed by the standard-setters and their results so far.*

Key words: fair value accounting, standard-setters, financial crisis, derivatives

Rezumat: *Criza financiară declanşată pe piața creditelor ipotecare din Statele Unite ale Americii încă din vara anului 2007 a atins cote neaşteptate în 2008 şi s-a răspândit cu repeziciune în toată lumea, producând haos pe pieţele financiare globale. Pierderile suferite de giganții financiari americani au generat blocaje şi pe piața imobiliară sau pe cea auto. În mai puțin de un an, bilanțurile marilor companii financiare au arătat active puternic depreciate şi pierderi importante datorate lipsei de lichiditate a anumitor pieţe sau active. Încrederea investitorilor s-a redus simțitor iar criza financiară a declanşat criza economică. În acest context, discuții aprinse s-au purtat în rândul bancherilor, asigurătorilor, auditorilor sau politicienilor în legătură cu găsirea vinovaților de producerea actualei crize şi, desigur, cu soluțiile de urmat pentru depăşirea sa şi prevenirea unor situații asemănătoare pe viitor. Lucrarea de față îşi propune să stabilească care este rolul contabilității în declanşarea crizei şi perpetuarea acesteia, să evalueze măsurile luate de organele competente şi rezultatele vizibile ale acestora.*

Cuvinte cheie: contabiliate la valoarea justă, normalizatori, criză financiară, derivate

INTRODUCTION

Despite the fact that the whole world became aware of a massive financial crisis only by September 2008, the specialists could read its signals at least a year before. The first clue was the collapse of the two hedge funds owned by Bear Stearns after an important investment on the sub-prime market. During 2007, many other financial institutions found out that their normally safe securities were tainted by the so-called “toxic mortgages”.

The beginning of 2008 was marked by the action took by the Federal Reserve in order to stave off the bankruptcy of Bear Stearns (the Fed assumed 30 billion $ in liabilities and engineered its sale to JP Morgan Chase). In September 2008 the events taking place on the American markets became of international interest, spreading their consequences all over Asia and Europe. The rescue of Fannie Mae and Freddie Mac which were placed under government control, the bankruptcy of Lehman Brothers, the sale of Merrill Lynch to Bank of America, the 85 billion $ injection got by AIG from the Treasury were extraordinary events that lead Bush administration to the decision of drafting a plan to fight the crisis – the already famous 700 billion $ bail-out plan. By October 2008 the crisis had already crossed the ocean. The European officials decided that bail-out packages were needed for the banking sector and governments promised to guarantee private savings accounts to prevent massive withdrawals. In a matter of weeks, the financial crisis affected economies all over the world.

It became very clear that the economic consequences of the financial crisis were very significant and the plans drafted as a response were very expensive. All this lead to debates concerning the causes of these events and the people/rules to be blamed for. Opinions were divergent, but many bankers and insurers accused fair value accounting of the actual crisis and its propagation.

MATERIAL AND METHOD

This paper aims at determining the role played by accounting and financial reporting during the present crisis by analyzing and discussing the numbers reported in the interim financial statements (quarterly statements) of some American financial institutions. We considered that these reports were the most relevant to establish the impact of fair value accounting on the balance-sheets because the American institutions were the most affected by the crisis. We underline that the annual financial statements for 2008 are still in preparation, a small number an entities having them already published, therefore the analysis is made upon the quarterly reports of 2008.

Moreover, our examination takes into consideration the most important measures adopted by the accounting standard setters as a response to all the critics and as part of the plan of improving the financial reporting used by investors and creditors.

For the first part of our analysis we used mainly three studies conducted by different bodies (such as Securities Exchange Commission – SEC, Merrill Lynch and Financial Accounting Standards Board - FASB) in order to assess the impact of fair value accounting on financial institutions. The results of these studies are, in our opinion, important to respond the critics of mark-to-market accounting (as part of the fair value accounting).

The report published by SEC analyzed a sample of 50 financial institutions of which 27 were banks, 12 insurance companies and 5 broker-dealers and highlighted:
-the weight of the assets and liabilities measured at fair value in the total assets and liabilities reported on the balance-sheet;
-the effects of changes in fair value upon the income statement;
-the use of fair value option (that is the voluntary election to measure certain assets and liabilities at fair value);
-the impact of the adoption of SFAS 157 and SFAS 159 (both dealing with fair value) on the balance-sheet;
-the nature of assets and liabilities measured at fair value;
-the impact of fair value accounting on bank failures in 2008.

Merrill Lynch's report analyzed the recent bank failures and losses recorded by this industry and identified the main causes of these evolutions. The FASB staff also examined institutions that did not survive the crisis and, in addition, compared the market value of some important commercial banks to their book value.

For the second part of our study, we took into consideration the recommendations made by different prudential, banking regulators and supervisory agencies (Committee of European Banking Supervisors, Financial Stability Forum, Institute of International Finance, Basel Committee, International Banking Federation, International Organization of Securities Commissions etc.) for the accounting standard setters. Therefore, we analyzed the measures adopted by the accounting bodies (the round-tables, the amendments of old rules dealing with recognition and measurement of financial instruments or disclosures on fair value, the exposure drafts and additional guidance issued), underlining the promptness and the quality of their responses to the recommendations received.

RESULTS AND DISCUSSIONS

After studying the aforementioned reports, we came to the conclusion that the numbers clearly showed that fair value accounting did not cause the current financial and economic crisis. It did not play a meaningful role in bank failures which were caused, more likely, by credit losses due to fraudulent lending, by lack of appropriate management risk and excessive leverage, by creation of complex financial instruments and by the absence of prudential regulations.

We support our opinion on the following results taken from the US SEC's report:
-only a minority of 45% of total assets and 15% of total liabilities were measured at fair value by the companies in the sample;
-on industry basis, banks reported only 31% of total assets as measured at fair value;
-25% of the total balance-sheet assets of the financial institutions were reported at fair value through profit and loss (for banks the percentage was 22%);
-4% of total assets were reported using fair value option, respectively 5% of total liabilities;
-the adoption of SFAS 157 and SFAS 159 did not significantly change the percentage of assets/liabilities measured at fair value (for assets: 42% as of year-end 2006 – before the adoption to 45% as of first-quarter year-end of 2008 – after

the adoption, for liabilities: 8% as of year-end 2006 – before the adoption to 15% as of first-quarter year-end of 2008 – after the adoption)
-the main types of assets measured at fair value were: investment securities, trading instruments and derivatives recognized as assets, derivatives and trading accounts liabilities respectively;
-76% of total assets measured at fair value and 84% of liabilities belonged to the 2nd level of the fair value hierarchy, 15% of total assets (11% of total liabilities) were included on the 1st level and 9 % (5% respectively) were level 3 instruments.

Therefore, the conclusions are: less than half of the assets held by financial institutions were measured at fair value according to the relevant accounting standard and the percentage of the liabilities recorded at fair value was quite small. Moreover, an even smaller percentage of assets/liabilities were reported at fair value through profit and loss, the changes in the fair value being recorded into other comprehensive income rather than into the income statement. We also noticed that the main types of assets/liabilities measured at fair value were the trading ones (that is, the instruments held for short-term profits) and the derivatives for which there were no regulated markets with transparent information to be used in determining their fair value. That is why we do not find anything surprising in the fact that the majority of the assets/liabilities reported at fair value do not fit on the 1st level of the fair value hierarchy (which includes the most liquid instruments whose value stems from quoted prices in active markets), but on the 2nd level, where fair value is calculated using observable market data other than quoted market prices (that is, data that require adjustments involving a certain degree of subjectivity).

The report published by Merrill Lynch upholds the anterior affirmations and states that the main cause of the failures and losses were the poorly performing loans which were not accounted for at fair value but on an accrual basis of accounting. This means that losses were gradually recognized and added to the income statement (and not immediately, as in fair value accounting) as they (the losses) actually incurred. And yet, the financial institutions came close to bankruptcy. This could only mean that credit loss provisions had a greater impact on banks' financial position than the impact of mark-to-market losses.

It is nonetheless important that securities issued by many banks affected by the crisis were traded on the market below their book value. This situation suggests that investors do not trust the financial reports and view the banks' net asset as overstated and not understated as many of the fair value critics imply. They argue that fair value irrationally reduces the value of a business without taking into consideration its intrinsic value. It seems that the investors, as the main users of the financial statements, do not agree.

As regards the measures taken by accounting bodies (Financial Accounting Standards Board – FASB and International Accounting Standards Board – IASB), we noticed both the joint efforts of the two standard-setters and the individual responses to the recommendation made by the Financial Stability Forum or the G-20 during the Summit on Financial Markets and the World Economy in

November 2008. The measures were prompt and lead to long-term projects meant to improve fair value accounting and financial reporting.

On the whole, the American accounting body – FASB- took the following actions:

-monitored the implementation of SFAS 157 on fair value measurements by establishing the Valuation Resource Group which provided information on implementation issues pointed out by practitioners, auditors and valuation experts;

-issued, in September 2008, alongside the SEC staff, a news release addressing additional fair value measurement clarifications;

-issued, in October 2008, additional guidance to clarify the application of SFAS 157 in inactive markets;

-completed deliberations on two projects amending the existing standards on transfers for financial assets and consolidation of special-purpose entities;

-initiated a project to improve the application guidance used to determine fair value and disclosure of fair value estimates due to release by the end of the second quarter of 2009;

-undertook four short-term projects regarding impairment, fair value disclosure requirements, embedded credit derivatives and reversal of previous recognized impairment.

The international body – IASB – had its own agenda including:

-the amendment of IAS 39 “Financial instruments: recognition and measurement” and IFRS 7 “Financial instruments: disclosures” in order to allow reclassification of some financial instruments out of the fair-value-through-profit-and-loss category and out of the available-for-sale category;

-the amendment of IFRS 7 to require additional disclosure similar to the one requested by the American standard (SFAS 157);

-the issuance of an exposure draft to amend IAS 27 “Consolidated and Separate Financial Statements” (redefining the term of control of an entity).

The two bodies jointly held three round-tables to gather views on most urgent accounting issues and to establish a way of approaching them in order to restore the investors’ confidence. IASB and FASB also created the Financial Crisis Advisory Group to assist them in evaluating the problems and identifying the improvements necessary in financial reporting.

In our opinion, the effects of all these actions would be better quantifiable when the quarterly reports for 2009 are released.

CONCLUSIONS

After analyzing the published research reports and examining the opinions on the role played by the accounting rules during the current crisis, we came to the following conclusions:

-although they can be improved, the accounting rules (especially the ones regarding fair value) are not to blame for the crisis and its spreading for which other profound causes can be identified. Placing the blame on accounting is a lot

like shooting the messenger for bringing bad news about the situation of certain financial institutions that did not take the most basic precautions;
-the main critics of fair value accounting who turned out to be exactly those responsible for the crisis were silenced by the results of the aforementioned studies;
-accounting is hardly responsible for enhancing financial stability (which is a task for the market regulators), its role consisting of providing useful and neutral information to the users of financial statements (even though it may expose the deterioration of the financial condition of an institution). Therefore, accounting should not be used as a means of providing financial safety and soundness because this could affect its transparency and cannot be used as a tool to fight against procyclicality because this could affect its neutrality;
-fair value accounting should not be eliminated or suspended, not even during a crisis, because the investors consider it the best existing valuation method for financial instruments even though it could still be improved through further guidance and disclosures.

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