Introduction

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Financial Reporting in the ‘New Era of Responsibility’ – A Brief Note

Obviously, a textbook on international accounting written in late 2008 and early 2009 has almost by necessity to dwell, at least to a certain extent, on conceivable financial reporting consequences resulting from the present financial crisis. On 20 September, 2008, the US government admitted that the financial system was on the verge of total meltdown. In order to avoid a risk of systemic failure the former US Treasury Secretary, Hank Paulson, designed a plan to ensure money-market funds, cut the troubled assets out of the banking system and nationalize around $700 billion of the banks’ balance sheets – equivalent to a third of the British economy (Becker et al., 2008; Baker, 2008). Hank Paulson concluded that the ‘financial regulatory structure is sub-optimal, duplicative and outdated’ (BBC News, 20 September, 2008). Within a few days the financial crisis spread from the US to the rest of the world and is believed to have had a recessionary effect on the rest of the economy.

To prevent the kind of systemic risk-taking among banks that has contributed to the current financial crisis, the new US Treasury Secretary, Timothy Geithner, is outlining comprehensive plans to strengthen government authority over the US financial system. Mr. Geithner told a US House Committee that the financial system ‘needs to be subject to strong oversight by the government’, and he called for more openness and transparency (BBC News, 26 March, 2009). The treasury secretary also talked of ‘unwise’ risk-taking and a failure of ‘market discipline’, and said that ‘regulated institutions held too little capital relative to the risks to which they were exposed’ (ibid.). Mr. Geithner outlined five elements of a plan to achieve a better, smarter, tougher regulation: (a) establishing a single entity responsible for stability among major institutions, (b) enforcing more conservative capital requirements for financial institutions, (c) forcing investment companies of a certain size to register with the Securities and Exchange Commission (SEC), (d) establishing a framework for derivative markets, and (e) strengthening requirements for money market funds (ibid.).

Former Federal Deposit Insurance Corporation (FDIC) Chair, William Isaac, placed much of the blame for the financial crisis on the SEC and its fair value accounting standards, especially the requirement for banks to ‘mark-to-market’ (fair value used on an ongoing basis) their assets, particularly mortgage-backed securities (CNBC, Brooke Sopelsa, 9 October, 2008, Former FDIC Chair Blames SEC for Credit Crunch). Whether or not this is correct has been the subject of ongoing debate (c.f., Forbes, 2009; Barr, 2008; Deans and Mott, 2008). Critics of fair value accounting standards are claiming that valuing assets at fair value forces firms to record hard-to-sell assets at ‘fire-sale prices’. The resulting write-downs, the critics maintain, have fed a negative spiral of tumbling asset values and plunging stock prices as firms raised huge sums of money to shore up thinning capital reserves (Barr, 2008). On the other hand, some accountants and investors
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put forward a different view, saying that mark-to-market accounting provides vital transparency of companies' financial health; the write-downs, they contend, reflect nothing more than poor economic judgments made during the boom that ended last year (ibid.). For some institutions, this triggered a margin call, where lenders that had provided funds using mortgage-backed-securities (MBS) as collateral had contractual rights to get their money back (Yu and Shenn, 2008). This resulted in further forced sales of MBS and efforts to obtain liquidity to pay off the margin call; mark-downs may also have reduced the value of the banks’ regulatory capital, requiring additional capital-raising and creating uncertainty regarding the health of the banks (Katz, 2008).

According to Westbrook (2008) it is the combination of the extensive use of financial leverage (i.e., borrowing to invest, leaving limited room in the event of a downturn), margin calls and large reported losses that may have exacerbated the crisis.

The argument is that the ‘mark-to-market’, or the fair value method of measuring assets at market prices, sometimes is flawed when markets have ceased to function. On 30 September, 2008, the SEC and the Financial Accounting Standards Board (FASB) issued a clarification as to the implementation of fair value accounting in cases where a market is disorderly or inactive (SEC, 2008-234). This guidance clarifies that forced liquidations are not indicative of fair value, as this is not an ‘orderly’ transaction. In addition, it clarifies that estimates of fair value can be made using the expected cash flows from such instruments, provided that the estimates reflect adjustments that a willing buyer would make, such as adjustments for default and liquidity risks (ibid.).

The Emergency Economic Stabilization Act of 2008 was passed and signed into law on 3 October, 2008. On 7 October, 2008, the SEC began to conduct a study on ‘mark-to-market’ accounting, as authorized by SEC.133 (SEC, 2008-242).

On 10 October, 2008, the FASB issued further guidance to provide an example of how to estimate fair value in cases where the market for that asset is not active at a reporting date(FSP FAS 157-3, 2008).


On 10 March, 2009, Federal Reserve Chairman, Ben Bernanke, said, ‘We should review regulatory policies and accounting rules to ensure that they do not induce excessive [swings in the financial system and economy]’. Although Bernanke does not support the full suspension of the fair value accounting principle, he is open to improving it and to providing ‘guidance’ on reasonable ways to value assets to reduce their procyclical effects (Torres and Lanman, 2009).

On 16 March, 2009, the FASB proposed allowing companies to use more flexibility in valuing their assets under fair value accounting, a move that could ease the balance sheet pressures that many companies say they are feeling during the economic crisis (Scannell, 2009: a). On 2 April, 2009, the board ratified most parts of the proposals (Scannell, 2009: b).

Also in Europe political pressure was exercised over accounting standard setting to mitigate the effects of the financial crisis on the financial system. For example, in October 2008, the European Commission forces the IASB (International Accounting Standards Board) to allow banks to reclassify debt securities from ‘trading’ to ‘hold to maturity,’ backdated to 1 July (Zeff, 2009).

The IASB has responded to the financial crisis by launching various activities, of which one is setting up, together with the FASB, the Financial Crisis Advisory Group,
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which will consider financial reporting issues arising from the financial crisis (IASB, April, 2009).

IASB and FASB have also so far jointly held three public round tables in London, Norwalk and Tokyo to identify accounting issues that might require the attention of the boards.

One relevant accounting issue relating to the crisis is accounting for off-balance sheet entities. That is, some entities may not have appropriately accounted-for special purpose entities (SPEs) used for securitization transactions. Given that the Enron used SPEs in a dubious way, one may argue that IASB should hasten when it comes to the improved regulation of SPEs (or, ‘structured entity’, according to ED 10 Consolidated Financial Statements).

A related issue is that some entities have ceased to account for assets they still control, which might not give the reader a true and fair view of the underlying economic reality. The questions are when entities should stop accounting for assets transferred to other entities, and what are the disclosure requirements?

Another project that may be organized under the heading of IASB activities relating to the financial crisis is IFRS 7 Financial Instruments: Disclosures. The objectives of the proposed amendments to IFRS 7 are to improve disclosures about fair value measurement of financial instruments and about liquidity risk, and to improve disclosures about investments in debt instruments. More specifically, users of financial statements may need further information on how entities estimate the fair value of their financial instruments when there are only limited market data to support those estimates (IASB, April, 2009).

Fair value measurement has been a recurring theme even before the (latest) financial crisis. The IASB has realized that there is a need for guidance on how to measure fair value across accounting standards, and in March 2009 the IASB published a request for views on proposals from the FASB for amendments to fair value measurement. Furthermore, the IASB has a long-term project to replace IAS 39 in order to reduce its complexity and produce more relevant and reliable information for users.

According to a global poll published by BBC World Service (Schifferes, 2009), 70 per cent of those who responded across the 24 countries polled think ‘major changes’ are required to the way the global economy is run. Furthermore, the majority in most countries – on average 68 per cent – also see the need for major changes to their own country’s economy. This may indicate a need for increased transparency of financial information. At the conclusion of the London Summit (the G20 leaders’ meeting in London) a broad consensus emerged towards placing the Financial Stability Forum (FSF) on stronger institutional ground (Draghi, 2009). Accordingly, the FSF has been relaunched as the Financial Stability Board (FSB), with an expanded membership and a broader mandate to promote financial stability.

At the London Summit, President Barack Obama said the summit could mark a ‘turning point’ in the pursuit of economic recovery and that it had made progress in reforming a ‘failed regulatory system’. And, he continued to talk about a new era of responsibility. At this summit one working group was established to suggest how to improve international regulatory standards (G20, 2009). One suggestion the working group came up with was that accounting standards should improve as to the recognition of loan-loss provisions and decrease the unfavourable activities associated with fair-value accounting (ibid.).
The present financial crisis was largely caused by ill-judgment and poor decisions in politics and in the corporate world. Hopefully, one consequence of the financial crisis might be better leadership and management. And, since President Barack Obama’s administration represents a genuinely new and modern leadership style, this leadership style may also impact the business world.

Accounting is sometimes described as involving performing two roles, specifically stewardship (contracting) and investment (valuation), where stewardship concerns how well a company’s economic resources have been managed (c.f., Riahi-Belkaoui). According to Skinner (2008, p. 194), the basic idea behind the stewardship of financial reporting is that financial statements afford information useful for contracting among various parties of the enterprise. Moreover, the information requirements of those who manage capital are distinguished from those who manage resources; capital is homogeneous while resources are not (Ijiri, 1995, p. 55). Although the primary objective of the IFRS-based financial statement is to provide information useful for decision making, financial statements should also explicitly present the results of the management’s stewardship of the enterprise resources. Obviously, good judgment in decision making is a key to stewardship (c.f., Ijiri, 1975; see also Ijiri, 1995). Then, the question arises of how can financial reporting contribute to better informed and sounder judgements in corporate decision making? Or, differently put, how can financial reporting contribute to improved quality of management, given the (relatively speaking) diminishing power of shareholders and the increased significance of business enterprises?

Different suggestions and guidelines have been put forward how to achieve good corporate governance and accountability, for example within the disciplines of corporate governance and internal control. However, this note suggests a somewhat different, but complementary, mechanism for controlling the quality of corporate management. According to Deegan and Uneman (2006, p. 268), the stakeholder theory and legitimacy theory, or, more broadly, institutional theory, could be applied to explain why business entities adopt particular accounting techniques. These theories view the business enterprise as being part of a wider social and economic system, in which the enterprise is assumed to be influenced by, and in turn to have influence upon, the society in which it operates. The idea presented in this note is to let the various stakeholder groups have their say about the management, for example, in the form of rating how well they are doing. How this may be done in practice can be discussed in a public debate. The important thing is that the focus is set on the quality of management, on which we all are dependent. Furthermore, this note suggests that the outcome of this rating might be published in financial statements, maybe in the form of an unaudited supplementary disclosure, while the management might be given the opportunity to make their comments on the stakeholders’ views in the Management Commentary, for example.

This book is the result of a written assignment given to students on a master’s level course in international accounting at Linköping University. The assignment was based on the pedagogical notion of ‘students write for students’. The idea is that students can promote the learning of other students by giving a comprehensive review of a theme or subject matter in an easy-to-read format. That is, the students are given an active teaching and partaking role. The present book, Convergence in Financial Reporting – From a Student Perspective, is a good case in point. Each review is laden with references, and extensive summary and discussion sections form an integral part of the review. References to the ongoing discussion on accounting harmonization and convergence are made. Questions
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that seize the essence of the reviewed theme conclude the review. These questions may be useful, for example, in class discussions, or as suggestions for thesis subjects. Each review covers a chapter and each chapter covers a specific theme related to the ongoing harmonization of accounting standards. Together, the chapters relate to significant aspects of the notion of convergence in financial reporting – from a student perspective.

The introductory chapter discusses two roles of accounting; corporate governance and corporate valuation and also different accounting standards. This chapter also discusses the current convergence and harmonisation processes. The next chapter discusses how the development of Chinese accounting is connected to the political and economic development of China. The chapter will also talk about the harmonisation with the IFRS and how Chinese accounting of today differs from the IFRS; while the following chapter starts with a discussion of the problems concerning financial statements. The standards that this chapter focuses on are IFRS 1, IAS 1 (which includes Phase A and B) and Management commentary. The subsequent chapter concerns IFRS for private entities. In 2004, IASB started the work of creating a new financial reporting framework for private entities. This framework is a lighter version of the already existing IFRS. The chapter presents a detailed background to the project and the proceeded work so far. The next chapter explains the current joint project between the IASB and the FASB and its progress. Theoretical models that are being developed by the work groups are also explained. Finally, the differences between the IASB and the FASB are pointed out. The chapter that follows covers the work in process of the new IASB standard of insurance contracts. The criticisms and the discussion about alternative methods of measurement for the new standard that the IASB will present are also presented.

Whereas the next chapter talks about the proposed merger between IAS 27 and Standing Interpretation Committee (SIC)-12 regarding consolidated statements. This merger will result in a new IFRS which will replace IAS 27 and SIC-12. The chapter also addresses the underlying factors of how the merged standards will replace the existing ones. The concluding chapter discusses the standard IAS 12 - Income taxes and its FASB equivalent, Statements of Financial Accounting Standards (SFAS) 109 - Accounting for income taxes. The chapter also contains the decisions made regarding the harmonisation of them. Finally, the chapter considers the effect these two standards might have on the connection between accounting and taxation.

References


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