AAA 2010 Annual Meeting – Panel Proposal

"Accounting and the financial crisis"

Jointly organized by Y. Biondi and S. Sunder

Special Panel for the American Accounting Association Annual Meeting, San Francisco, 2 August 2010, ID Number: 001986, 2:00 pm-3:30 pm

Abstract

What could improve the financial system and protect the public exchequer in the future? What accounting model is the most suitable for designing and implementing a resilient financial system in the public interest? An upgraded framework, of a controlling and governance nature, should be drawn up. It should be robust to transactions, instruments, and organizations that arise endogenously in response to regulation. The accounting system of financial institutions and business firms may then constitute the proper basis for the internal systems of remuneration and control.

Presentation

When financial institutions that had been judged "too-big-to-fail" failed, governments and central banks spent huge amounts of public funds to rescue them. The stated justification was to save the world economy from the network effects of such failures. Part of this public money ultimately contributed to remunerate the coauthors of the financial crisis. The mark-to-market accounting that had facilitated large and unrecoverable transfers to these employees during the period of rising prices was conveniently suspended when the market prices fell. The supposedly better information provided by mark-to-market valuation for decision-making did not succeed in imposing prudential constraints on financial institutions to protect the whole economy from systemic risks. The question remains: has systemic risk been reduced and mechanisms devised to contain it in the future? Have emergency responses set the world up for more severe problems later?

The answer appears to be factually negative. Concentration in the financial services industry has increased. The incentive structures that induced decisions at the root of the financial crises of recent decades remain in place. The creation, growth, and risk-taking by private financial institutions were not supposed to lead to systemic crunch and chains of bankruptcies in a "free market" dynamics. Mark-to-market accounting was adopted when it facilitated higher reported profits, leverage and compensation, but abandoned when it meant reporting losses and lower bonuses. What are the alternatives to giant institutions out of control, and mark-to-market accounting? What are the plus and minuses of the current state of financial affairs?

The size of financial institutions and their systems of accounting and control

What could improve the financial system and protect the public exchequer in the future? Would a financial system with smaller structures be more transparent? A new framework, of a controlling and governance nature, should be drawn up. It should be robust to transactions, instruments, and organizations that arise endogenously in response to regulation. The accounting system of financial institutions may constitute the proper basis for the internal systems of remuneration and control. Mark-to-market systems have failed to provide appropriate incentives during the crisis. This makes increasingly clear that remunerations and other distributions of profits should be based on the realized financial performance and position, whilst the prudential constitution of regulatory reserves may follow a counter-cyclical mechanism. In 2000, the US Congress passed a law making contracts for difference (CFDs) (i.e., transactions in financial derivatives) legally enforceable even if they are not traded on a regulated exchange (which has a clearing house and transparent balance of positions). This change in law opened the way for the financial markets to become giant legal casinos operating in an opaque and unregulated domain. Legal enforceability of off-exchange CFDs should be removed. This institutional nexus constitutes the underlying framework of the problems with the size of financial institutions (firms) and with the proper accounting system for the economy of them.

Size. Antitrust protection has provided the traditional rationale for intervening in the size of firms in order to limit market power and promote competition to improve economic efficiency. In the 1920s, it was suggested that the size of industrial firms should be limited in order to prevent manipulations of the markets and abuses of economic power. A century later, such abuse played an indisputable role in the events leading up to the government bailouts of giant financial institutions. The aim of the bailouts was to safeguard the domestic and global economies, but they also point to the urgent need for limiting the size of financial organizations. Without putting limitations on the size of such organizations, regulatory proposals are likely to fail.

Accounting. Effective implementation of size limits or other prudential regulatory devices (such as prudential ratios or reserves) requires a rethinking of the accounting system on which regulatory actions are based. Mark-to-market accounting allegedly assumes that financial risks can be identified, reported, and managed by basing accounting reports on external market prices. This putative advantage must be weighed against the consequences of creating information asymmetry in favor of the giant, opaque, regulated entities factually operating in noisy and thin markets. In contrast, prudential regulation should be based on reliable information that is disclosed and traced over time, in line with the financial performance and position that have been generated by reasonably-sized financial institutions. This accounting report may be complemented by prospective information on future obligations and the coverage of them through historical time.

Control. This accounting system of prudentially-regulated institutions may constitute the proper basis for the internal systems of remuneration and control. Mark-to-market systems have failed to provide appropriate incentives during the recent crisis. This makes increasingly clear that remunerations and other distributions of profits should be based upon the realized financial performance and position, whilst the prudential constitution of regulatory reserves may follow a counter-cyclical mechanism.

Enforceability. In year 2000, U.S. Congress passed the law which made contracts for difference (i.e., transactions in financial derivatives) legally enforceable even if they are not traded on a regulated exchange (which has a clearing house and transparent balance of positions). This change in law opened the way for the financial markets to become giant legal casinos operating in opaque and unregulated domain. Even casinos with bets of a quarter are not permitted to do so unregulated. Legal enforceability of off-exchange contracts for difference should be removed.

Organization and outcomes

Under the auspices of the recently established transnational and interdisciplinary journal “Accounting, Economics and Law – A Convivium”, published by *The Berkeley Electronic Press* (www.bepress.com/ael) and edited by Reuven Avi-Yonah (University of Michigan School of Law), Yuri Biondi (Cnrs – Ecole Polytechnique of Paris) and Shyam Sunder (University of Yale School of Management), featured speakers will join this session and discuss along these issues of size, accounting and enforceability – in order to envision ideas and perspectives for the development and implementation of a more resilient and responsible financial system in the public interest, at the domestic and global levels.

Speakers

Shyam Sunder (Yale University) – “Norms and Regulation: Accounting beyond the Financial Crisis”

Yuri Biondi (Cnrs – Ecole Polytechnique of Paris) – “Share Price Formation, Financial Instability and Accounting Design: an accounting lighthouse in the share price dynamics”

Gao Pingyang (Chicago Booth School of Business) – “Where Does the Information in Mark-to-Market Come From?”

Bob Colson (Grant Thorton) – “accounting regulation and policy at the aftermath of the financial crisis”

Contact and further details: yuri.biondi@free.fr