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Relevance and Credibility in Financial Accounting and Reporting

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I am quoted as follows in the June 1992 issue of The Journal of Accountancy.

> I do not think the users of financial statements have been well served over the last 10 to 15 years.... I think financial accounting and reporting have lost some of their credibility, and we need to improve their relevance.

I want to continue that theme today.

Almost all of Washington and almost all of the banking, insurance, and thrift industries are pleading with the Financial Accounting Standards Board not to adopt mark-to-market accounting for debt securities held as assets. Congressmen, banking regulators, and the Secretary of the Treasury are saying that it would be wrong to change from historical cost to mark-to-market accounting for debt securities such as US treasuries, agencies, state and local governments, and mortgage-backed securities held by banks, thrifts, credit unions, and insurance companies.

Why do I think we should jettison historical cost accounting and adopt mark-to-market for marketable securities? The reasons are simple and straightforward.

The first reason is usefulness. One does not use historical cost numbers to make investment or lending decisions. No banker has ever made a collaterized loan to a customer based on the customer's historical cost of the collateral; the banker insists on knowing the market value of the collateral. No investor in any asset ever made an investment based on the seller's cost of the

asset. No investor in a bank's stock, or a depositor with funds in excess of $100,000, or an annuitant or other insurance company policyholder should be asked to rely on the historical cost of a bank's or insurance company's investment in bonds. Congress established in ERISA that pensioners need to know the market value of pension plan assets; no pensioner would be satisfied with the historical cost numbers for pension plan assets. Congress, in the Investment Company Act of 1940, required that all mutual funds mark-to-market their assets; broker/dealers do the same under the 1934 Act; mark-to-market is necessary so that customers and investors have up-to-date useful information to make investment and credit decisions. People that invest in or loan money to banks, thrifts, insurance companies, and credit unions deserve the same treatment.

The second reason is managed income. Historical cost accounting for debt securities allows management of an enterprise to manage income; that is, management can select when it sells securities and thereby trigger a realized gain or loss. Preparers of financial statements often object to volatility of income in general. In this case, volatility is recognized in the period that management wants it to be recognized, not when the volatility actually occurs in the market value of the securities. The same amount or degree of volatility is present; it is just recognized in a different accounting period.

Moreover, if management wants to paper over a bad quarter or year because of, for example, bad debts being charged to income or because a hurricane requires an insurer to pay a lot of claims, management "cherry picks" some winners from the bond or stock portfolio and sells them so as to offset the bad debt loss or the hurricane claim losses. We have observed that phenomenon repeatedly.

More importantly, this discretion promotes wide noncomparability in reported income and capital (shareholders' equity). We all know that 1991 was a good year for bonds. Some holders of bonds sold the bonds, reaped the gains, and thereby increased income and capital. Other holders of bonds did not sell; those holders have unrealized gains residing in their balance sheets. Even with disclosure of realized and unrealized gains and losses, that condition makes it very hard for the investing public to compare, for example, Bank A or Insurance Company A with Bank B or Insurance Company B. Financial accounting and reporting should make comparable things look comparable, and should make comparison easier not harder.

The third reason is interest-rate risk. Historical cost is used for debt securities provided management has the intent and ability to hold those assets on a long-term basis or to maturity, so called accounting by psychoanalysis. Many financial institutions currently use their bond investments to "manage" interest-rate risk, to manage foreign exchange risk, to manage taxable income, to manage liquidity, and to respond to loan demand. As we have seen in the last several decades, interest rates fluctuate widely. So do foreign exchange rates. So does loan demand. Managers of financial institutions respond by buying or selling securities. Management is responding to outside, uncontrollable forces. These responses are inconsistent with representations about intent to hold for the long term or to maturity. It is not credible to assert that one intends to hold bonds in the bond portfolio for the long term or to maturity while saying in the same breath that the investment securities portfolio is used to manage interest-rate risk or is sold in response to loan demand.

A stated intent to hold to maturity or for the long term is an empty promise, an incorrect assertion, if it is broken or

contradicted when interest rates change, loan demand rises, or some other uncontrollable event comes along and management decides to sell so-called investment securities.

A fourth reason for the use of market value involves credit losses. Holders of corporate bonds should, at least in theory, recognize credit losses as the credit standings of bond issuers decline. But that's theory. In practice, holders of corporate bonds do not recognize credit losses until the bond issuer is bankrupt or nearly so. Independent auditors condone this practice because the accounting rule is so judgmental and abysmally lax that loss recognition is delayed far beyond reason. The Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and state insurance regulators learned that, too late.

On that score, we now have an exposure draft of a new accounting standard from the FASB on the recognition and measurement of credit losses, which the Board calls loan impairment. Under the proposal, loan impairment would be recognized "when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." When a loan is judged to be impaired under the standard of probability, the creditor would measure impairment by reference to the present value of the expected future cash flows of the impaired loan using the effective interest rate of the loan. For loans with no discount or premium or net deferred costs or fees, the effective rate is the coupon rate. The FASB considered using a market rate instead of the effective rate but decided on the effective rate. The Board apparently never considered any other measure of impairment than the probability standard applied to expected cash flows.

I am very disappointed in the Board's conclusions on both of those matters. First, the probability standard does not work; that has been demonstrated by the wide variability in current practice. The General Accounting Office has been extremely critical of that approach; GAO's criticism is based on its review of failed banks where the allowances for credit losses were badly understated. Saying that it must be probable that the principal and interest will not be collected is looking down the wrong end of the pipe; a lender assumes that principal and interest will be collected as per the loan agreement and then allows for risk through the rate.

Second, despite some cautionary words, the draft allows the measure of impairment to be made independently of market prices and what market participants think about a debt issuer's credit. Assume that a bond is traded on the New York Bond Exchange and that interest rates have not moved a tick since the bond was issued. The bond can be quoted at an amount less than 100, say, 95, 90, or 85, yet the holder of that bond judgmentally may conclude that it is not probable that the loan will not be collected as per schedule and therefore no impairment need be recognized. Under FASB Statement 107, the fair value of that bond will have to be disclosed somewhere in the financial statements of the holder of that bond. I think that the public will not understand how it can be that two values are being reported and disclosed for the same bond, 100 and an amount less than 100, say, 95, 90, or 85. I think the public will be confused. I think the public will conclude that impairment as measured by the market is the relevant measure of impairment and not the amount as measured under the FASB's standard. I think that the FASB's proposal will diminish its standing in the eyes of the public.

What I am most concerned about, however, is the measurement of capital. This is more than one accountant's debate with another accountant about the best way to allocate a cost among various

accounting periods. I am talking about more than accounting elegance. How we measure loan impairment concerns whether financial institutions should be required by the cognizant regulator to raise more capital or reduce their asset holdings and liability levels, or, indeed, whether they may keep open their doors.

A fifth reason for mark to market is market efficiency. Free markets are wonderful things. Ours are marvelous. Markets price assets daily, hourly, and by the minute, at no cost. Use of historical cost for assets and such notions as intent to hold to maturity and "other than temporary declines" in price interfere with market efficiency. To the extent that market place participants believe that the reported numbers have been skewed by artificial restraints, the market exacts a penalty in pricing the securities issued by reporting companies.

A sixth and final reason concerns capital adequacy. Financial institutions have explicit or implicit capital-adequacy requirements. Banks, for example, must have $8 of capital for every $100 of "risky" assets, such as loans. Under the accounting rules, declines in market values of debt securities are not recognized if the holder has both the intent and ability to hold the securities to maturity or on a long-term basis. Whenever the price of a debt security goes below the historical cost of the security, reaching a conclusion that the enterprise has the ability to hold the security to maturity implicitly requires an interest-rate forecast. First, management of the reporting enterprise must conclude that, even though interest rates have risen, that condition will not persist so long that the enterprise will be forced to sell the security at its reduced price to get cash to meet obligations. Alternatively, the management must conclude that interest rates will fall in the near term, the price of the security will increase, and the enterprise will not have to sell

the asset at a loss. Then, the enterprise must get its independent auditor to agree to that forecast, at least implicitly.

Second, the reporting enterprise must conclude that its regulator will allow it to continue to operate and not force it to sell the security at its reduced price even though the real capital of the enterprise is impaired. The enterprise must get its independent auditor to agree with that conclusion as well, at least implicitly.

I think that it is not within the competence of independent auditors to make interest-rate forecasts, and independent auditors should not be responsible for judgments about forbearance from laws and regulations. I think that it is the responsibility of banking, thrift, insurance, and credit union regulators, and ultimately the Congress and the public, to decide when forbearance from laws and regulations is appropriate, not independent auditors. Besides, once an independent auditor has agreed that a decline in market value below cost need not be recognized and thereby not reduce the reported amount of capital, he or she then becomes wedded to that decision and will not reverse it because to do so is to admit error, or at least fallibility, not to mention the exposure to litigation. The auditor then has a vested interest in the client's interest-rate forecast and psychologically may no longer be independent in the deepest meaning of that word.

The critical point here, however, is regulatory forbearance. Under a recent FASB standard--FASB Statement 107--all entities will have to disclose the market value of their marketable securities portfolios, both debt and equities. Many assert that with those disclosures the cognizant regulator has all the information necessary to make regulatory decisions. True. Marking-to-market right on the face of the financial statements will not change the facts; what marking to market will do is require regulatory

authorities to make explicit decisions about whether regulated enterprises have met their capital requirements, whether those enterprises need to raise more capital, reduce their assets and liabilities, or indeed whether they may keep their doors open to the public. Those explicit decisions then cannot be postponed or sloughed off as they can if the mark-to-market is only in the footnotes and not formally accounted for on the face of the financial statements. I am talking about something more than bean counting by people wearing green eyeshades. I am talking about more than accounting elegance. I am talking about whether financial institutions that are entrusted with the public's money are allowed to keep open their doors and take in more of the public's money.

Look what the use of historical cost got us in the savings and loan debacle. The final tally will not be in for years, but the cost to the American taxpayers, and society in general, will be enormous.

The use of historical cost did not cause the S&L problem, but the use of historical cost is to blame for the loss of some of that money down the S&L hole. Because the S&Ls could say that the acquisition, development, and construction arrangements were loans and not real estate, and were fully collectible, but did not have to disclose their fair value, never mind write the ADC loans down to fair value, ADC loans kept growing and growing on S&Ls' balance sheets. Accounting income from such loans also kept growing, even though no cash income was being collected. For the marketable securities and regular residential mortgage loans that S&Ls held, and which were significantly under water in the high interest rate environment of the early to mid-1980s, no write down was required by the applicable accounting standard, or at least practice under that standard, so long as the S&L had the stated intent and ability

to hold the securities and loans to maturity. Historical cost was OK.

So, even though it was known by the S&L regulator that real equity of the S&Ls was a huge negative number, the S&Ls were allowed to stay open and to keep making risky investments with taxpayers' money. They kept rolling the dice. When the FSLIC and FDIC took over the failed S&Ls and savings banks, however, they found that the size of the hole was huge. But under generally accepted accounting principles, no hole, or only a small hole, had been reported. None of the S&Ls, or their auditors, had critically examined whether the S&Ls had the ability to hold those assets. That ability was wholly dependent on the S&Ls' not being shut down by the regulator, and was therefore of very questionable fact. The analysis was circuitous. The regulator implicitly said that the S&Ls would not be shut so long as reported equity was positive, and the S&Ls kept accounting for their marketable securities and mortgages at cost so long as the regulator did not shut the doors; the circle was closed; thus, the parties involved were able to say that the ability-to-hold criterion was met.

If the S&Ls had been forced to disclose, never mind account for, the fair value of their ADC portfolios and their bond and mortgage loan portfolios, does anyone honestly believe that the S&L hole would have gotten as deep as it got? I think the fair answer to that question is "No."

Let me turn to a closely related matter, namely litigation against public accounting firms, which also involves relevance and credibility in accounting. Litigation is said to threaten to obliterate a significant portion of the profession, or least that portion of the profession that audits the financial statements of public companies. The profession is going to various State capitals and to Capitol Hill in Washington asking for relief from

various laws. The profession claims that it is the subject of abusive and frivolous lawsuits by shareholder/investors. Members of the profession also cite cases where their "deep pockets" have been opened to pay for the sins of more culpable, but now insolvent, audit clients. The profession is lobbying hard for litigation reforms, including a major push to restrict joint and several liability.

I am very concerned about abusive litigation against accountants. So is the Commission. The Commission has suggested that Congress look at proportional versus joint and several liability. The Commission has stated its support for RICO reform. The Commission has stated its support for the proposition whereby the loser of non-meritorious litigation pays the winner's costs. Getting reform through the Federal Congress and the various states, however, will take a long time, if it ever comes.

Meanwhile, the profession, with a few exceptions, is not doing anything about the underlying causes of litigation against itself. It will not pull on its own bootstraps. The profession will not go to its clients and tell those clients that their balance sheets have to have realism in order to elicit unqualified opinions. Why not? Well, that could involve being tough with a client. Maybe make the client angry. Maybe the client will go across the street to another auditing firm and that firm will agree to report on a balance sheet that has outdated or irrelevant representations in it.

The profession, again with an exception or two, will not go to the FASB and support realism in financial accounting and reporting. The profession will not reach tough unpopular decisions. Why is that? Is it because the profession has become so beholden to its clients that it will not speak to them about realism and relevance and credibility in financial accounting and

reporting? Let me list only a few situations where the profession has become a cheerleader for its clients.

1. Troubled debt restructurings. The profession, in response to its bank clients, asked the FASB to issue FASB Statement 15 more or less as the FASB did back in 1977. That document allows for restructured loans to be reported at 100 cents on the dollar even though that dollar will earn no interest and will not be collected until many years in the future. FASB Statement 15 has plunged an entire generation of accountants into darkness. Fortunately, the FASB now is proposing to change that standard so as to remove that part of it which is so grossly bad, but the new FASB proposal itself is flawed because of measurement of the loss on in-substance foreclosed assets by use of the effective rate rather than a market rate.

2. Pension plan values. When pension accounting was being reconsidered, the profession, at the behest of its commercial and industrial clients, went to the FASB and suggested that the volatility in pension plan assets and liabilities not be recognized immediately and in full in income and equity. They argued that the FASB should create an artifice to keep the income statement and shareholders' equity from being affected too much by changes in the values of plan assets and liabilities. The FASB obliged in Statement 87, and now we have delayed recognition of changes in values of plan assets and liabilities.

3. Deferred tax assets. APB Opinion 11 produced deferred tax asset and liability numbers that no one could explain. When the FASB fixed that problem in Statement 96 a few years ago and permitted the recognition of deferred tax assets only when the amounts could be recovered through the operation of a

carryback, the profession, at the behest of its clients, let out a howl. Even though it clearly was not in their best interest to do so, all of the large accounting firms went to the FASB and pleaded with the Board to allow recognition, on a judgmental basis, of deferred tax assets that will be recovered, if at all, years and years into the future and only if there is future taxable income.

The FASB obliged in Statement 109. The claim was, under old Opinion 11, that the deferred tax liability was a "UGO," an "unidentified growing object," because the amount kept getting larger and larger. The deferred tax asset under FASB Statement 109 has the potential to be a "UGO" in reverse.

What are the users of financial statements going to do when they see those deferred tax assets? If they're sophisticated, they are going to exclude those assets from income and equity or discount them heavily. If they aren't sophisticated, I don't know what they will do. What is going to happen when those deferred tax assets are not realized? I know what will happen. The accounting firms will be sued.

4. Investment versus trading. In 1990 and 1991, we have seen financial institutions sell 25%, 50%, 75%, even 95% of their entire self-designated investment securities portfolios during the year despite their assertions in the footnotes that they intend to hold the securities to maturity or for the long term. One insurance company turned its long-term US Treasury bond portfolio eight times in 1991. Yet, remarkably, every one of those institutions' financial statements received the unqualified opinion of its outside auditor.

5. SEC filings. In SEC filings, we sometimes see what I call incredible accounting. When our staff challenges the

accounting, it becomes clear that the auditor did not concur with his or her client's accounting, but nonetheless signed an unqualified opinion hoping that our staff would challenge and object to the accounting and thereby become the bad guy. Our staff is being used as the auditor's leverage, but only after the auditor agrees to the incredible accounting.

6. I could list other examples, but I have made my point.

What is the purpose of my bringing this issue to the fore? Well, I think that instead of thinking simply of its clients and itself the profession needs to give some thought to the public that it serves--to the investors and creditors and employees who put up their money and their labor to make investments in the profession's clients.

I suggest that the profession go to the FASB and ask it to issue accounting standards that produce more relevant, more understandable, more useful, and more credible financial statements than what we now have. That the profession ask the FASB to issue accounting rules that produce bullet-proof balance sheets instead of what we now have. Bullet proof in the sense that assets are not stated in excess of market values. That the profession ask the FASB to issue accounting rules that respond to and correspond with real-world, outside-of-accounting phenomena, like market values of assets instead of such arcana as undiscounted cash flows and delayed recognition of changes in value of pension plan assets and liabilities. That the profession ask the FASB to issue accounting rules that result in financial statements that investors can understand and use instead of accounting rules that are arcane and idiosyncratic and produce financial information that only other accountants can understand.

The accounting profession keeps saying that instead of reporting real assets, hard assets, at current value, its clients should continue to be able to use historical costs and deferrals

and allocations of costs and losses and that the profession should then be able to apply its judgment to the recoverability of the amounts of deferrals reported by its clients. But the profession then says, when it is sued, that it should not be held responsible when those deferrals and those judgments turn to clabber instead of cream. I submit that if reporting companies published relevant, credible balance sheets that are bullet-proof the profession would not get sued. Or, if it got sued, the plaintiffs would not prevail on the merits.

What if those who are crying wolf are right? What are the implications of a major firm being bankrupted by damage awards because of overstatement of asset values? I truly hope that does not happen. That would be tragic for any firm and the individuals involved. Investors would suffer. But what if it does happen? What would that imply for the Securities and Exchange Commission? Would that suggest that the Commission step into the accounting standard-setting process and require that assets not be reported in balance sheets at amounts in excess of market values? Would that suggest that the Commission mandate rotation of auditing firms so as to make it more likely that auditors who know they will be replaced will not allow clients to report assets in excess of market values? I do not know the answer to those questions, and I do not want to find out.

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I urge the Financial Accounting Standards Board and the accounting profession to address the issues of relevance and credibility in financial accounting and reporting so as to maintain their own relevance and credibility.

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