WHERE'S THE BEEF?

People are still blaming financial reporting for the financial crisis. Brian Singleton-Green, Faculty Manager, looks at the evidence.

Almost as soon as the global financial crisis dawned, some critics blamed it on fair value accounting. The gist of the argument was that banks' profits were inflated during the boom years by massive fair value gains. Their accounts, it has been said, were 'misleading to the point of treachery' and – it is alleged – they paid out in cash 'colossal accounting profits that [were] largely imaginary'. When the market turned, these imaginary gains were reversed and the banks collapsed. If only they had used historical cost, these problems could have been avoided.

This argument has not gone away. But further on into the crisis a more sophisticated critique appeared. This focused on the banks' historical cost accounting. It was claimed that the 'incurred loss model' that the banks were required to use to calculate loan impairments understated their losses in the good times. They should have used an 'expected loss model' instead. Some critics drew a different conclusion. If only the banks had used fair value, they said, these problems could have been avoided.

So perhaps it's really quite simple. We should have used fair value wherever we used historical cost and historical cost wherever we used fair value.

As the financial crisis – or at least its first phase – is now past, it's reasonable to assume that those who place the blame on financial reporting will by now have some evidence to support their claims. If they have, so far they've kept it to themselves.

It's quite possible that the evidence will emerge, and I certainly don't intend to stick my neck out and say that it will never be found. The theoretical models that explain how accounting caused the crisis, or made it significantly worse, are elegant and even persuasive. It's just that I haven't seen the evidence for them yet.

Those who have studied the facts in some depth conclude that fair value did not play a significant role. In a lengthy report published at the end of 2008, the US Securities and Exchange Commission found that bank failures in the US were not attributable to fair value accounting, but were 'the result of growing probable credit losses, concerns about asset quality, and…eroding lender and investor confidence'. It reached a similar conclusion for US investment banks.

An important study in the *Journal of Economic Perspectives* by eminent academics Christian Laux and Christian Leuz finds the same. In 'Did fair-value accounting contribute to the financial crisis?' they conclude that, 'based on existing evidence, we have little reason to believe that fair value accounting contributed to banks' problems in the financial crisis'.

Another useful empirical study is *Fair Value Accounting: Villain or Innocent Victim* by Sanders Shaffer of the Federal Reserve Bank of Boston. This concludes that, for the sample of banks reviewed, fair value accounting had 'a minimal impact' on their capital. Instead, 'capital destruction was due to deterioration in loan portfolios and [capital] was further depleted by… proprietary trading losses and…dividends'.

As for the incurred loss versus expected loss argument, I have seen no research at all on this.

Even the March 2010 Valukas report into Lehman Brothers' failure, which appears to identify clear deficiencies in its accounting, does not attribute its collapse to these defects.

The crisis was, surely, caused by imprudent property-based lending, and securitisations based on that lending, which assumed that property prices would carry on rising. They didn't. When property prices fell back, the lenders and those who held the related securities faced massive losses. You can elaborate on that explanation in various ways, but accounting, if it had a role at all, was just a bit player.

Back in the 1980s there was a TV ad in the US for 'Wendy's hamburgers'. It was aimed at rivals' products – all bun and no beef. In the ad, an elderly lady peered at an open burger and asked, 'Where's the beef?' The phrase passed into the language. When we look at the criticisms of financial reporting and its alleged role in the crisis, we may also ask, 'Where's the beef?'