Understanding practice & institutions

A prerequisite for successful accounting standard-setting

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2013 FINANCIAL MARKETS & CORPORATE GOVERNANCE CONFERENCE

Wellington New Zealand, April 4 & 5

Outline

- UK/US corporations and financial reporting evolve
- 2008 financial crisis illustrates that evolution
- Regulators learn from experience
- Expected changes to accounting & financial reporting
- Future of IFRS

Evolution of institutions

- Institutions evolve as conditions change
- Evidence suggests UK/US companies' organization and financial reporting has been influenced by the market at least as much as by regulation and politics
- UK/US financial reporting history provides evidence on the relative influence of those determinants

Market forces:
UK corporate & accounting examples

- Around 1620 English companies' **bearer** shares made enforcement of unlimited liability impossible
  - Companies could not borrow
- 1620 - New River Co. charter voluntarily restricts dividends to accumulated verifiable profits (market force)
- By 1920's market forces led to
  - Orderly liquidation accounting for balance sheet (bankers' statement)
  - Asset verifiability required to prevent paying dividends from capital
  - Verifiable earnings-based dividend provisions
  - Conservatism – higher verifiability required for gains than losses
  - Writing up to market restricted to verifiable property and liquid securities

Market forces' effect on US & UK Accounting by 1920s

- Income recognized as it became verifiable
  - Provided basis for assessing unverifiable, more timely information sources - increased information in general
  - Conservatism
    - Higher standard of verifiability for gains than losses
- Balance Sheet
  - Measured net assets or opportunity cost of staying in business (orderly liquidation value)
    - "Banker's statement"
  - Combined with income statement generated rate of return on assets & on equity

Market forces effect on US & UK Accounting by 1920s

- Unofficial accounting standards
  - Enforced by large audit firms with listed clients
- Conservatism
  - Higher standard of verification required for recognizing good news (increases in net assets) than for recognizing bad news (decreases in net assets)
  - Goodwill written off against reserves in UK, down to $1 in US (if possible)
- Mark-to-Market (MTM)
  - Property and investments occasionally marked-to-market
    - Property revaluations associated with refinancing
    - Investment revaluations involved actively traded securities
    - In both cases valuation was verifiable and/or incentives appropriate
  - Generally not applied to separable assets w/o active markets
    - Obvious reason was limiting manager's opportunity to mislead investors

Conservatism's information role

- Reason for conservatism
  - Managers had more knowledge of current and expected profits than shareholders and auditors
  - Could use that knowledge to mislead shareholders by increasing firm income
    - Earnings-based compensation existed by 19th century (Watts,1977)
- Conservatism in sophisticated stock markets
  - Stock prices are based on many information sources
  - Audited financial statements - *ex post* check on sources' reliability

Corporate governance adjustments

- Managers' incentives to increase **firm value** addressed by
  - Providing stock-price-based compensation in addition to earnings-based compensation
    - Stock price is forward-looking & verifiable
  - Delaying payment of earnings-based bonuses for one or more years

Accounting's role in valuation

- In 1920's the balance sheet provided a conservative estimate of the opportunity cost of staying in business
  - i.e., a conservative value of net separable assets (see Holthausen & Watts, 2001)

- Approach more consistent with stewardship (care of net assets) than with "fair" valuation
  - Fair value's lack of verifiability can generate considerable abuse – see later

Market forces vs Political forces

- Market forces determine accounting by trial and error
  - Firm innovations that improve reporting and increase firm value are imitated
  - Many firms try to improve reporting but only those innovations that are successful are imitated and survive

- Governments also try to innovate
  - Number of innovations limited relative to the market because there are more firms than governments in market economies
  - Means fewer successful accounting innovations come from the government

US Political Forces
1929 crisis & accounting

- Accountants received some blame for 1929 stock market crash & the depression (Holthausen & Watts, 2001)
  - Claims of overvalued assets
    - Empirical evidence suggests claims baseless (HW, 2001, p.35, Walker, 1992)
  - SEC given role of setting accounting standards and effectively outlawed asset write-ups after 1940
    - Some SEC original members affiliated with FTC's investigation of utilities' financial difficulties in 1930's blamed asset write-ups (Walker, 1992, pp. 5-6)

Increased impact of politics and regulation on US reporting

- Examples of evidence of political forces
  - Formation of the SEC
  - SEC Chief accountant realized reporting was diverse & subcontracted setting of accounting principles to profession
  - Active lobbying for particular accounting principles
    - e.g., GPLA, pooling
  - Class action lawsuits
    - Increased conservatism
    - No mark-to-market
  - Congressional interference in elimination of pooling
    - Ultimately led to FAS 142

The Evolution of Fair Value

1929

SEC bans write up of assets

1947

ARB 30 requires some write downs of marketable securities

1975

SFAS 12 allows firms to write up previously impaired securities back up to historical cost.

1993

SFAS 115 allows firms to use fair value for marketable sec. I/s effects depend on classification.

2006/07

SFAS 157/59 allows firms to mark all financial assets to fair value.

SFAS 157/159 "Fair" value

- Academics & regulators suggested assets & liabilities, particularly securities, be **"fair"** valued *even if market prices were not available*
- FASB introduced "fair" valuation for *individual* financial securities (both assets & liabilities), ***including those not traded***, in SFAS 157 (Sept., 2006) & 159 (Feb., 2007) for financial periods beginning after 11/15/07.
  - *Earlier application* was encouraged & many banks used fair value
- Management to choose whether or not to use FV for particular securities
- Marking **liquid** securities to market is consistent with conservative accounting pre-Securities Acts, marking **illiquid** securities and liabilities to FV is not
  - The illiquid security's value is typically not verifiable, allowing manipulation
  - Played a significant role in recent crisis & continues to play a role

Proposals vs practice

- Example of FV
  - Balance sheet generates estimated **equity value**
    - B/S that evolved from economic & political forces estimated **net assets**
  - Income statement backed out of estimated equity value change
    - Measurement model (FV)
    - Very different to the conventional income statement
  - Valuation of liabilities
    - **Not** what would have to be paid off in orderly liquidation

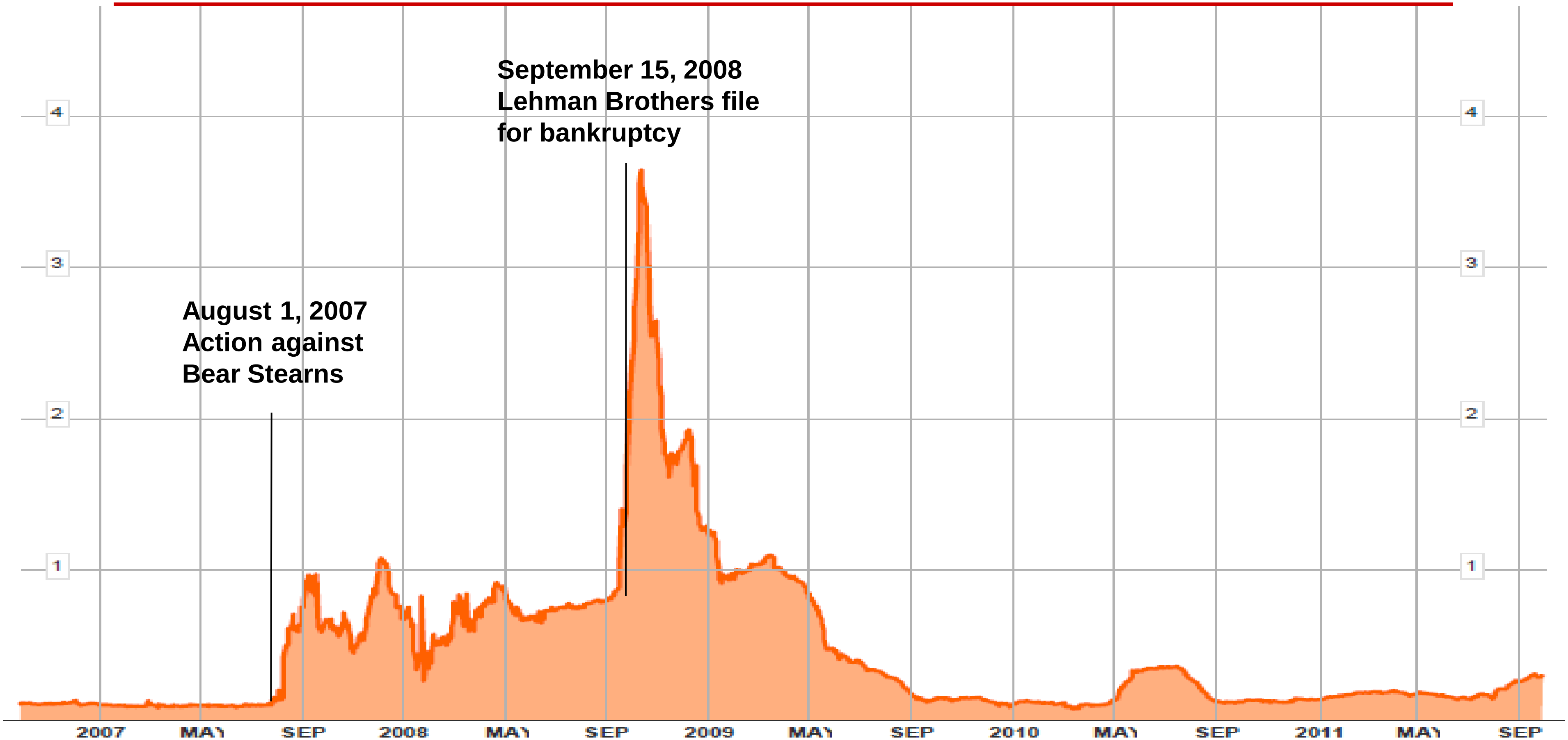
FV' s effects on practice

- Reported numbers meaningless in important situations
- Some evidence
  - Sub-prime securities move to level 3 FV with the financial crisis
    - No contagion, few write-downs, most overvalued
  - Valuation of goodwill under SFAS 121 & 142 (Ramanna & Watts 2012)
    - Managers tend not to write down impaired goodwill
      - **SFAS 142**
        31% of firms with goodwill & BTM (before impairment) >1 for 2 years impair in 2nd year
        Average BTM of those impairing is 1.5
      - **SFAS 121**
        15% of firms with goodwill & BTM (before impairment)>1 for 2 years impair in 2nd year
        Average BTM of those impairing is 3
    - Agency variables (self-interest of manager) tend to dominate decision
      Most important factor is whether CEO made the acquisition or not

Financial crisis

- In the week of July 16, 2007 Bear Stearns disclosed two of its subprime hedge funds invested in thinly traded collateralized debt obligations (CDOs) had lost nearly all their value
- On August 1, 2007 investors in the two funds took action against Bear Stearns & its directors & managers
- Markets began showing considerable uncertainty about the solvency of banks (information asymmetry concern)
- Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, 2008

3-month LIBOR-OIS Spread



Creating subprime securities

- **Brokers** originated subprime mortgages & sold to investment banks
- **Banks** packaged subprime mortgages from different areas, supposedly reducing risk, & issued securities against them
- **Securities** divided into different classes with different priorities
  - Supposedly the riskiest subprime securities could be sold to those who could evaluate them & absorb the risk

Slicing & Dicing - Subprime CDO

Subprime ABS (or RMBS) Deal*

Assets	Liabilities
Subprime residential mortgages	AAA bond
Assets underlying the ABS tranches are subprime residential mortgages	AA bond
	A bond
	BBB bond
	BB, NR

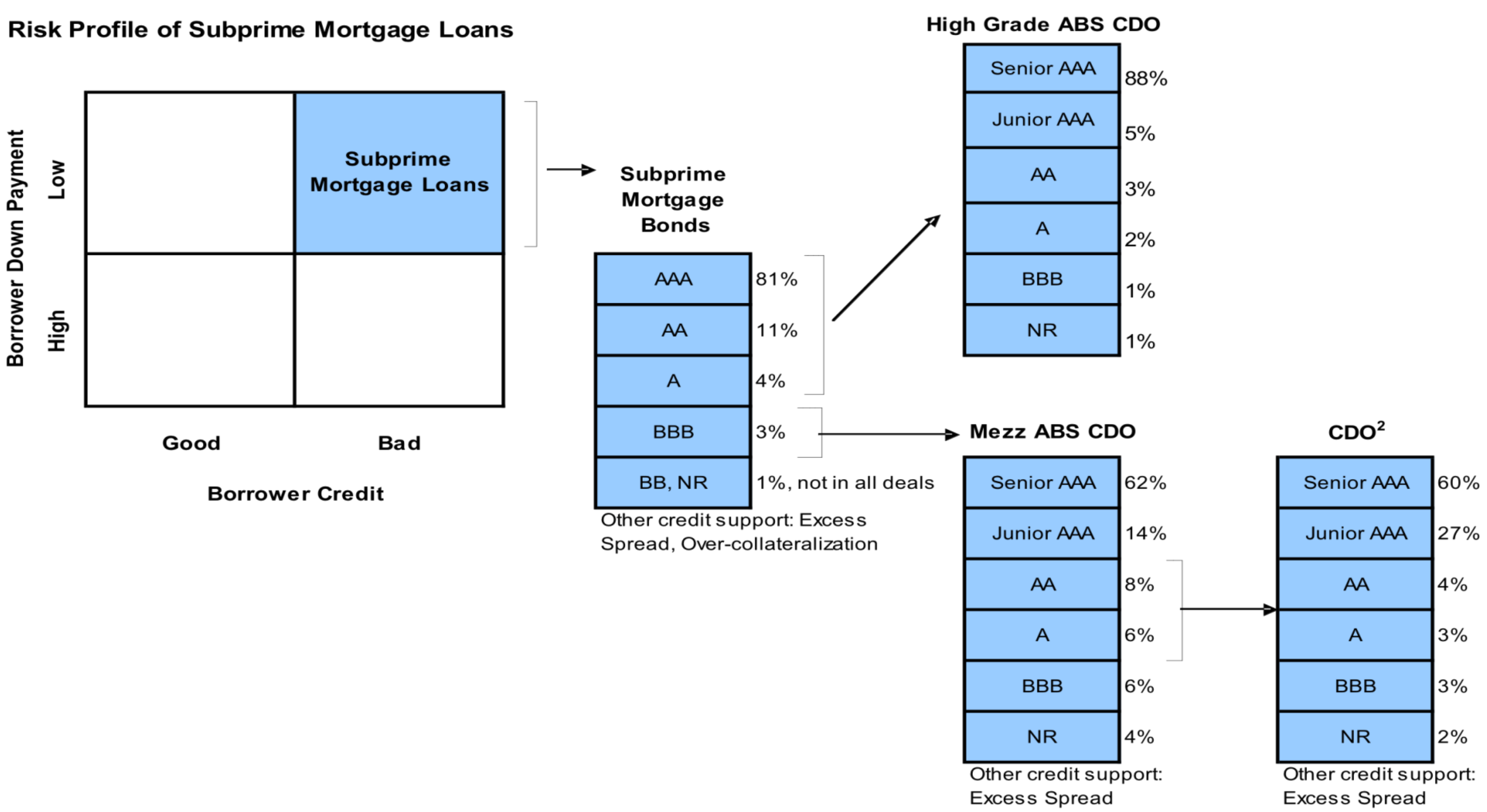
Subprime CDO$^+$

Assets	Liabilities
CDO assets are the liabilities of subprime RMBS deals	AAA bond
	AA bond
	A bond
	BBB bond
	BB, NR

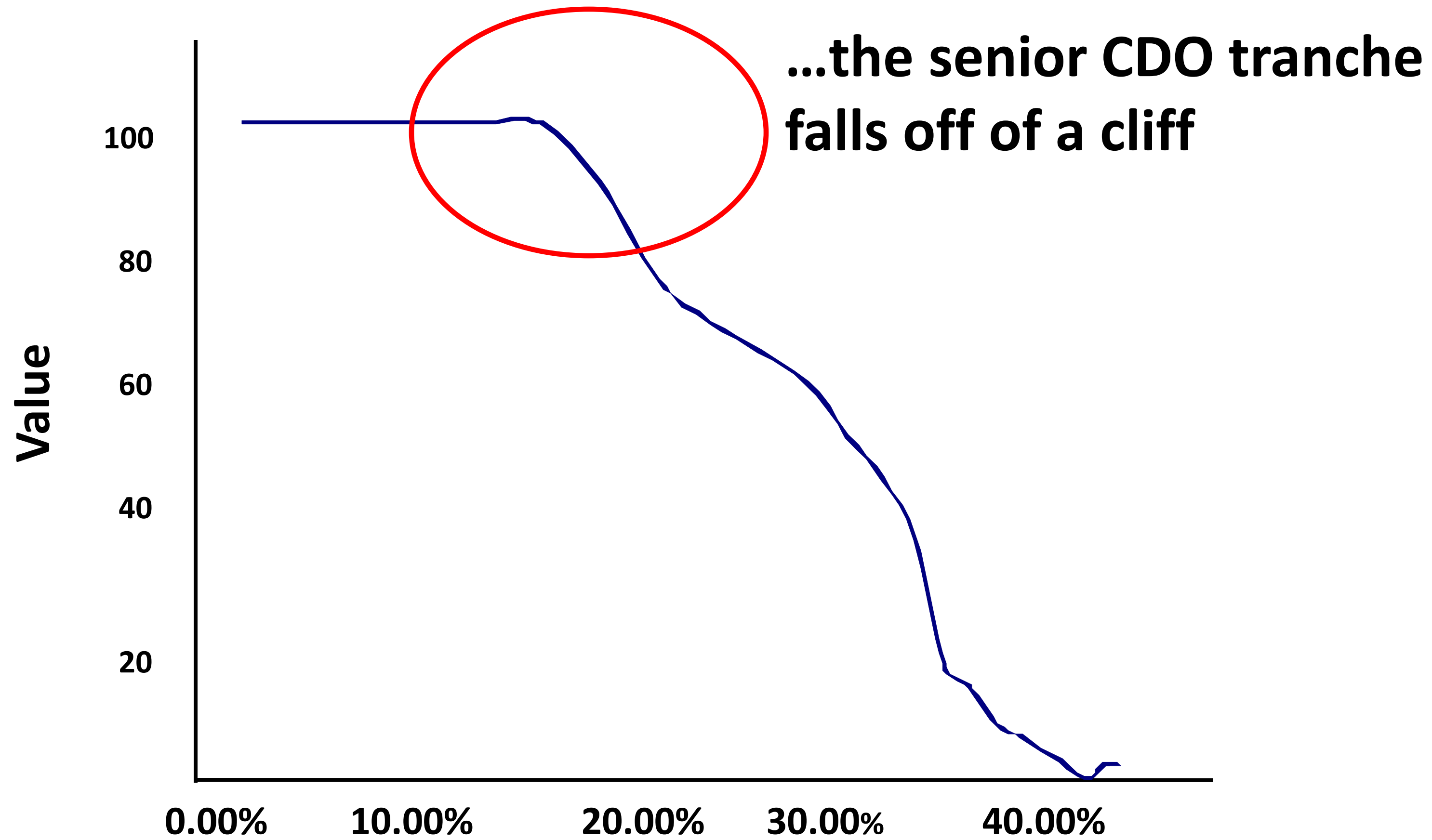
•ABS = Asset-Backed Securities

$^+$ CDO = Collateralized Debt Obligation

Subprime Loans ⇒ Subprime Bonds ⇒ ABS CDOs ⇒ CDO^2



Discounted Cash Flows of CDO vs. CNL of Underlying Mortgages



Cumulative Net Losses on Underlying Subprime Mortgages

Fair value did not help

- Banks tended to use fair value. Movement of *fair value* securities from valuation **level 1** (market price) to levels 2 or 3 (both unverifiable) is based on the nature of the evidence on value.
- Similarly securities are to be moved from **level 2** to level 3 based on the nature of the evidence
- Management **discretion** allowed in these rules combined to produce relatively **few write-downs** of either fair value or non fair value securities despite the high likelihood many securities' values were impaired
- Some hedge funds tried to generate transactions in subprime securities held by banks whose shares the funds had short sold
- Conservatism would have forced a write-down and reduced uncertainty

Valuation of subprime & other securities

- Dysfunctional use of accounting discretion (causing information asymmetry) didn't soon disappear
  - Huizinga & Laeven (2009) document that in 2007-2008
    - U.S. banks used discretion to continue to overstate distressed assets' values
    - Banks with large mortgage-backed security exposures provisioned less for bad loans
      - Poor stewardship or governance
  - It was not until the end of 2010 that uncertainty about counterparties was reduced

Other factors

- Factual errors & poor corporate governance also delayed loss recognition & uncertainty resolution
  - Factual errors
    - Argument losses fully insured – credit default swaps
    - Economists arguing securities underpriced
    - Economists worried about contagion
  - Poor corporate governance
    - Multiple valuations of securities
    - Risk managers vs traders

FV's effect on stewardship

- Deleterious effect on compensation incentives
  - Managers whose performance measures front-end loaded value (FV) had to keep granting mortgages & issuing securities to
    - Increase income & earn bonuses
    - Bank executive's example at Joint FSF-CGFS (central bank groups) financial stability forum, Paris, 2008
- Effect on quality of mortgages & securities
  - Caused managers to take on more & more low quality mortgages

Conservatism would have helped

- Earlier loss recognition would have
  - Caused financial institutions to face problem earlier
  - Limited real losses
  - Reduced uncertainty about bank securities' valuation

Actual effects of conservatism

- Conservatism's actual effects in bank accounting are
  - consistent with previous slide's predictions
  - inconsistent with central banks view - forward-looking accounting
- Beatty & Liao (2011) find **bank lending reductions** in recessionary relative to expansionary periods are
  - **lower** for banks that delay loss recognition less - **conservative banks**
- Watts & Zuo (2012) find **conservative firms**
  - **able to borrow more** from banks during the crisis period than non-conservative firms
  - **invest more** in the same period

Institutional ownership & conservatism

- Ramalingegowda & Yu (2012) find
  - Higher firm ownership by institutions likely to monitor managers is more associated with firm conservative reporting
  - Association more pronounced for firms with more growth options & higher information asymmetry
  - Lead/lag tests indicate monitoring institutions ownership leads to conservative reporting, not vice-versa
- Watts & Zuo (2012) find
  - Positive association between pre-crisis conservatism & institutional holdings
  - Association is stronger when there are greater agency costs
  - Association driven by long-term institutional holdings

Accounting standard-setting’s failure

- Allowing choice among valuation methods that included unverifiable methods such as fair value went against centuries of evidence on the necessity for verifiable accounting methods

- As the performance of the banks & firms using conservatism during the crisis shows

Did the auditors perform?

- Valuation of mortgages
  - Apparently recorded at face value (transaction price)
    - Ex ante strong default possibility on many subprime mortgage (FRB's Susan Bies, 2005)
    - Perhaps an expectation of government intervention
    - Ex post many transactions were overvalued

- Valuation of mortgage-backed securities
  - Difficult to value, especially higher level securities (CDO & CDO^2)
  - Many signals of overvaluation
    - Risk managers frequently ignored or fired (e.g., Rajan, pp.140-141)
    - Credit default swap prices apparently not questioned
      - Far too low
      - Large audit firms have experts in pricing

Why didn't the auditors perform?

- Expect some audit failures, but lack of discipline on subprime valuations seems excessive
- Has fair value had an effect?
    - Auditors appear to have acted as though checking the valuation process was sufficient rather than asking tough questions
    - Evidence in Ramanna & Watts (2012) on the lack of goodwill impairment suggests the former
    - As the FRC's Auditing Practice Board has suggested, there appeared to be a lack of auditor skepticism
- Have auditors lost control of their firms as Arthur Andersen's auditors appeared to have done?

Asset Valuations Trip Up Audits
WSJ, May 22, 2012

- Public Company Accounting Oversight Board found 123 audit deficiencies related to fair-value estimates and asset impairments in 2010, making asset valuation the most common audit problem.

- PCAOB says in certain situations auditors didn't provide enough scrutiny of management's forecasts, or didn't look closely enough at the assumptions and methodologies that went into the modeling used by corporate pricing services.

- These are not purely audit deficiencies. The problem is not only with the auditor, but with the FASB. FASB requires management to **guess** the fair value of assets. No one can do that accurately. The FASB fair value requirement in unverifiable situations is the problem.

Accounting's role in the crisis

- There were accounting & auditing failures
- Some failures are due to accounting standards & regulations that do not recognize the economic forces that shaped the nature of accounting & auditing throughout the long history of the Anglo-American company
- History suggests the failures will be corrected, by regulatory change, private economic evolution or both

Fundamental problem

- Firms' actual financial reporting practices are determined by economic & political forces
  - The only way you can satisfactorily explain those practices is in terms of those forces
    - For example, the FASB has no explanation for **why, on average, financial statements are still conservative** despite their opposition to conservatism for quite a few years
    - Yet the research literature has explanations for the existence of conservatism and evidence to support them
- Problem - those explanations require some sophistication about the supply of information to capital markets

Survey Evidence from CFOs

- The FASB and IASB recently dropped conservatism as a measurement principle from the joint conceptual framework (FASB, 2010)

- BUT, conservative accounting still exists and firms/banks embracing conservative financial reporting performed better in the financial crisis (Beatty and Liao, 2011; Watts and Zuo, 2012)

- Using survey evidence, Dichev et al. (2012) find a large majority of CFOs believe the FASB's de-recognition of matching, elimination of conservative accounting and over-emphasis of the fair value approach is misguided

Future directions for US

- FASB is now effectively an SEC Subsidiary
  - Conservatism attractive to bureaucrats (e.g. SAB 101)
- SEC answers to Congress not IASB
  - IFRS dead in US - see SEC final report on convergence
- PCAOB
  - Chairman Doty's evolutionary view of accounting & auditing
  - Pressuring auditors to force goodwill write-downs
    - Quotes to Watts & Zimmerman (JLE, 1983) in October London Speech

Future directions for other countries

- In practice many governments will not really cede accounting standard setting to IASB
    - Some **will bargain,** or **have bargained ,** out of specific standards
        - China is a good example
    - Governments will have different levels of enforcement